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ASIAN MONETARY MONITOR

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ASIAN MONETARY MONITOR

January-February 1996 **Vol. 20 No.1**

JAPAN
LEAKAGES WEAKEN MONEY AND CREDIT MULTIPLIERS

In the previous issue of the AMM, we investigated some of the changes in the demand for money resulting from deflation, negligible nominal deposit rates and rising (though still very modest) perceptions of risks associated with certain financial institutions. However, these same factors are also leading to changes in the behaviour of the banking system, i.e. in the supply of money. This article looks at the resulting changes in the balance sheet of the commercial banks, and the implications this may have for the effectiveness of the money and credit multipliers and for the outlook for Japan's economy.

Rising Liquidity Preference Weakens Money Multiplier

We have argued that extremely low nominal deposit rates and rising financial risk awareness has resulted in a "Rising Liquidity Preference of Money Demand" (AMM November-December 1995). In summary, the declines in short-term deposit rates have virtually eliminated the opportunity cost of holding money in the form of cash (0% interest rate) compared to holding it in an M1-type current accounts (0% interest), M1-type savings accounts (0.25-0.5% interest), or M2 3-12 month time deposits or CDs (0.4-0.6% interest). This effective elimination of interest differentials has made the distinction between M1 and M2+CDs largely irrelevant as maturing time deposits have flowed into cash and demand deposits, causing double-digit growth in M1, negative growth in time deposits, and virtually no change in the relatively subdued growth of M2+CDs overall.

Does the rising liquidity preference of money demand affect the behaviour of banking system and the money supply mechanism? Yes, because it reduces the proportion of M2+CDs available to banks for expanding credit to the economy. Most obviously, cash currency in public hands is a liability of the central bank, not of the commercial banks. A rise in cash as a proportion of M2+CDs reduces the proportion of M2+CDs which funds the activities of banks.

Less obviously, the different components of M2+CDs have different reserve requirements. As shown in the table below, reserve requirement ratios are lower for time deposits than for other deposits (i.e. demand and savings deposits) and higher for bigger banks than for smaller banks. As deposits have migrated from time deposits to demand and savings deposits, and from smaller to bigger financial institutions, the effective reserve requirement rate (required reserves as a proportion of total liabilities subject to reserve requirements) has risen from 0.43% at the beginning of 1994 to 0.45% in late 1995. Attributing the 3.8% year-on-year rise in average reserves outstanding as of last October (latest month with full data), we find that approximately 2.3% was due to the rising effective reserve requirement rate, 1.3% was due to a rising total amount of liabilities subject to reserve requirements, and only 0.2% was due to increases in banks' excess reserves.

Table 1: Deposit Reserve Requirement Ratios for Japanese Banks

Type of Deposit	Size of Deposit Base: Over Yen2.5 tn	Yen1.2-2.5 tn	Yen0.5-1.2 tn	Below Yen0.5 tn
Time Deposits	1.2%	0.9%	0.5%	0.05%
Other Deposits	1.3%	1.3%	0.8%	0.1%

The rising liquidity preference of money demand has thus contributed significantly to the recent increases in both currency in circulation and (via the increased effective reserve requirement ratio) in banks' reserves. Put together, these effects have led to an acceleration in the monetary base which has been interpreted by many observers as being a sign of expansion -- while both elements are in effect withdrawals from the funding available to Japan's commercial banks from M2+CDs. However, as the monetary base in Japan is only equivalent to 8.6% of M2+CDs, the overall effect of these factors on funding available to Japanese banks from M2+CDs has not been that dramatic. Chart 1 shows that Net Deposits+CDs (M2+CDs minus cash in circulation and legal reserve requirements) has followed M2+CDs very closely. However as cash currency has expanded and the effective reserve requirement rate has risen, so the growth rate of Net Deposits+CDs has decelerated somewhat below the growth rate of M2+CDs. Every coin has two sides, and money has to be viewed as both an asset of the non-monetary sector and a liability of the monetary sector. While M2+CDs is an appropriate measure of monetary assets of the non-monetary sector, it comprises liabilities of the whole monetary sector, i.e. both the commercial banks and the BoJ. By netting out the liabilities of the BoJ which are not available for commercial banks' balance sheet expansion, Net Deposits+CDs measures more accurately the amount of deposit funding for commercial banks and their resulting capacity to expand loans and other assets.

JAPAN: CHART 1
GROWTH OF M2+CDs, CASH CURRENCY AND NET DEPOSITS+CDs

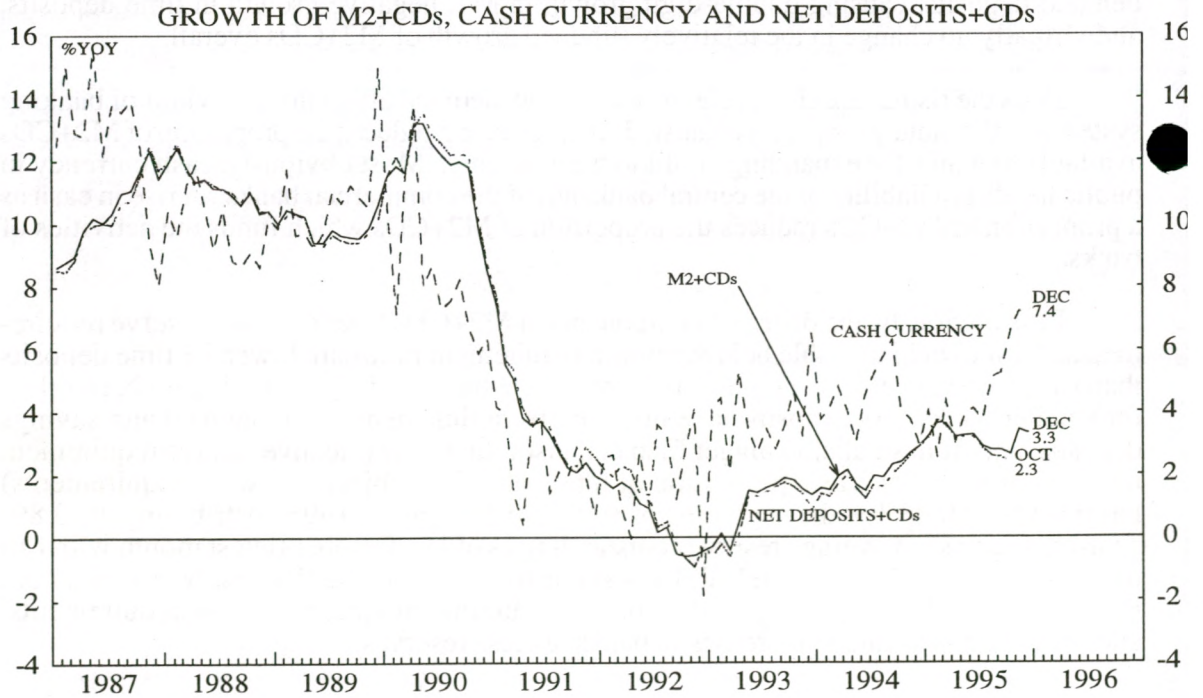
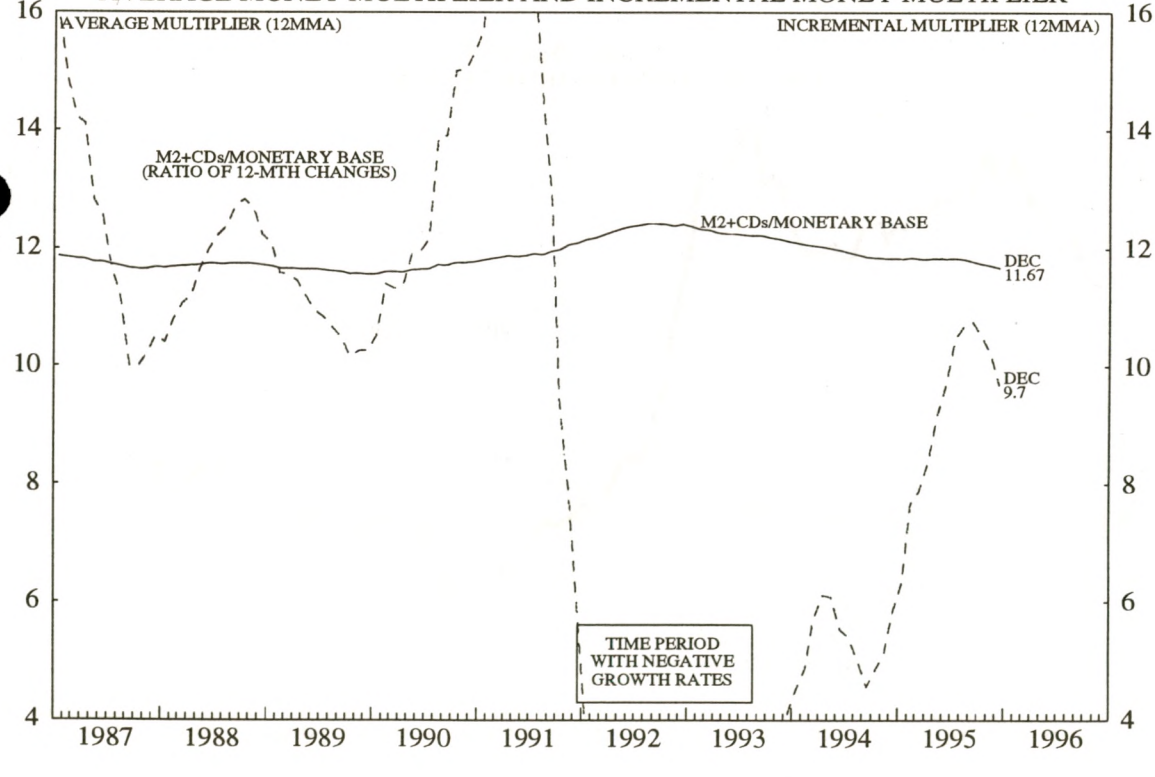


Chart 2 shows another way of expressing this trend in terms of what has happened to the money multiplier. The average money multiplier (M2+CDs as a multiple of monetary base) shows how much broad money is created for a given level of high-powered money. Given the extreme seasonality and volatility of the monetary base (mainly fluctuations in cash currency around New Years and mid-Summer gift-giving seasons) we have smoothed the series with a 12-month moving average to more clearly show its recent downward trend. Another way of more starkly showing this downward drift in the money multiplier is by looking at the incremental money multiplier (12-month change in M2+CDs divided by 12-month change in the monetary base) which shows how much additional broad money the banking system has created in response to injections of high-powered money by the central bank. It should be noted that since both the numerator and the denominator of the incremental multiplier has turned negligible and even negative for part of the post-bubble period, this ratio has to be treated with some caution. However, for periods when both the monetary base and broad money are exhibiting positive growth rates (such as the pre-bubble period and the period since 1994) the level of the incremental (or marginal) money multiplier tells us the direction of change in the overall average money multiplier. Looking at the latest observations, it should be clear that although the incremental money multiplier has risen from its trough, it is still significantly below the average money multiplier, on which it continues to exert downward pressure. Moreover, the levels of both the incremental and average money multipliers are significantly below pre-bubble historical averages. In concrete terms this weakening of the money multiplier means that the banking system now is significantly less effective at providing money supply to the real economy, and that it is misleading to think that rapid growth rates of monetary base (and other narrow money aggregates) automatically extrapolates into similarly rapid growth rates of broad money.

JAPAN: CHART 2
AVERAGE MONEY MULTIPLIER AND INCREMENTAL MONEY MULTIPLIER



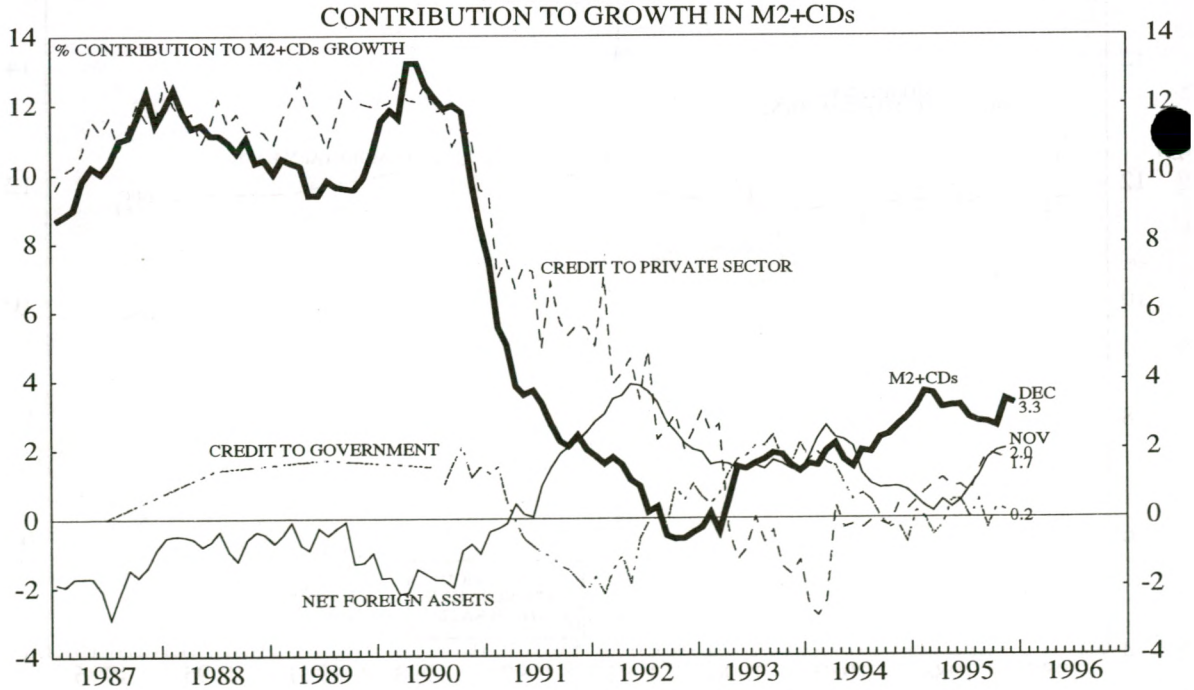
Leakages Weaken Credit Multiplier

Table 2: Monetary Survey Consolidated Balance Sheet

Liabilities	Assets
M2+CDs	Foreign Assets (Short-term, net)
	Domestic Credit to Government
Non-Deposit Liabilities	Domestic Credit to Private Sector

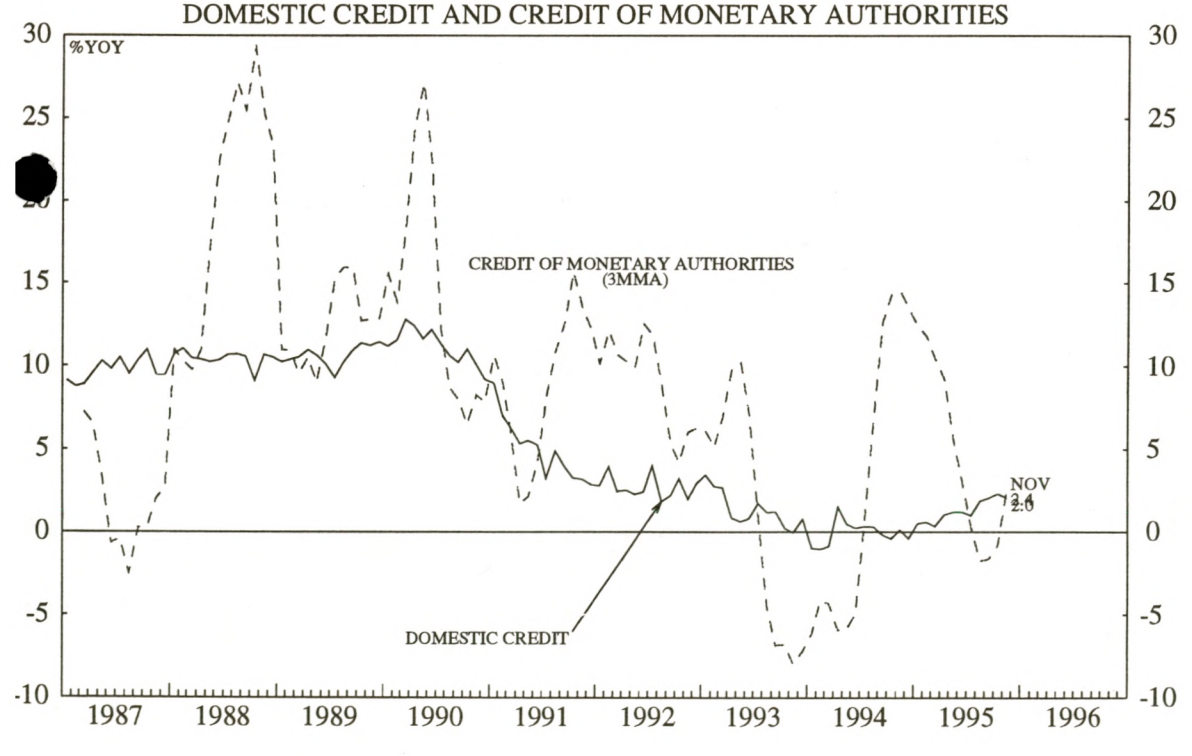
Creation of money and creation of credit are inextricably linked as counterparts on the balance sheet of the banking system. Any change in M2+CDs must by definition be reflected by offsetting changes elsewhere in the balance sheet of the monetary sector as shown in table 2. An increase in M2+CDs could thus either be matched by an increase in the domestic credit or net foreign assets on the asset side of the balance sheet, or be offset by a decline in other (non M2+CDs) liabilities of the banking system. Chart 3 shows the changes in the assets of the monetary system expressed as contributions to the year-on-year growth rate of M2+CDs. To prevent the chart from becoming cluttered we have omitted the contribution to growth in M2+CDs from changes in non-deposit liabilities, although it is worth noting that recently since the middle of 1995 as much of 0.5 percentage points of M2+CDs has come from net redemptions of bank debentures (a non-deposit liability outside M2+CDs) being credited to deposit accounts within M2+CDs. This is yet another example of how the rising liquidity preference arising from the low nominal interest rates available on both time deposits and on long-term bank debentures is affecting the monetary aggregates.

JAPAN: CHART 3
CONTRIBUTION TO GROWTH IN M2+CDs



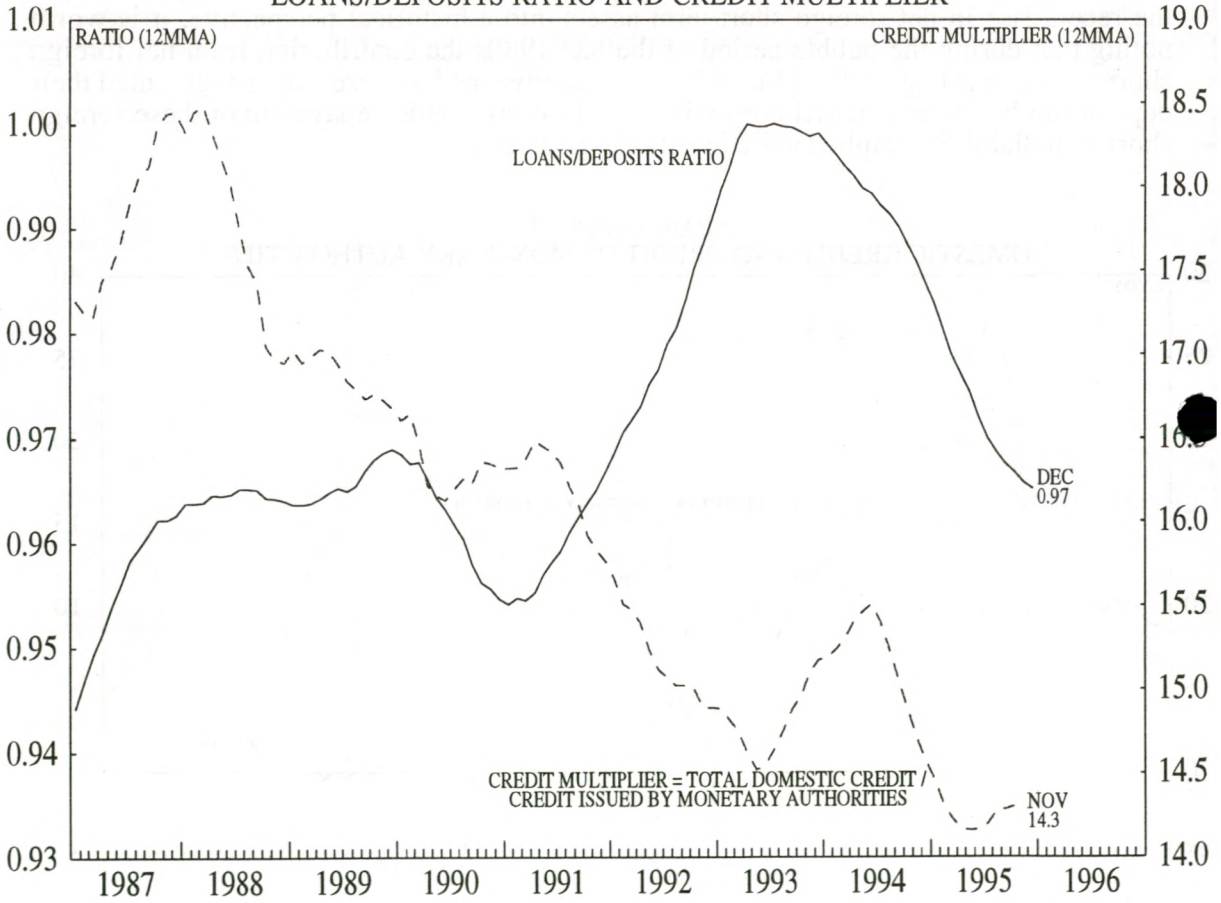
Among the credit counterparts to growth in M2+CDs shown in chart 3, there are several surprising features. In spite of claims by many observers that the government is providing the economy with significant monetised fiscal stimulus, increases in credit to the government sector (consolidated figures for both central treasury and local government borrowing) has since the middle of 1994 consistently made only a small (and often negative) contribution to growth in M2+CDs. Although bank lending has accelerated significantly from negative growth at the beginning of 1995 to 2% at the end of the year, the increases in claims on the private sector accounted for only 1.7% increase in M2+CDs. This was in part because an increasing amount of bank loans were extended in foreign currency. Increases in net foreign assets now account for 2% of growth in M2+CDs. Although some of this increase in net foreign assets may well have been loans to Japanese companies, this would not have been for domestic activity given the restrictions (only lifted in 1996) on settlement between Japanese companies in foreign currencies. More likely, the noticeable increase in net foreign assets since the middle of 1995 probably reflects loans by Japanese banks' head offices to overseas branches and subsidiaries to avoid the 'Japan Premium' and reduce the cost of funding their overseas operations. Given that increases in net foreign assets are not used to finance activity in the domestic economy, they represent a leakage from the financial system which serve to weaken the credit and money multipliers. As investment outflows, accumulation of net foreign assets also represents a drain on the flow of funds, and in national income accounting terms it represents a part of savings (a withdrawal) for which there is no domestic investment (i.e. injection) counterpart. To put the recent rise in net foreign short-term assets into a historical perspective, it is worth noting that during the bubble period of the late 1980s the contribution from net foreign short-term assets to growth in M2+CDs was negative, as Japanese banks augmented their deposit funding with external borrowing. In the early 1990s, repayment of these foreign short-term liabilities implied a rise in net foreign assets.

JAPAN: CHART 4
DOMESTIC CREDIT AND CREDIT OF MONETARY AUTHORITIES



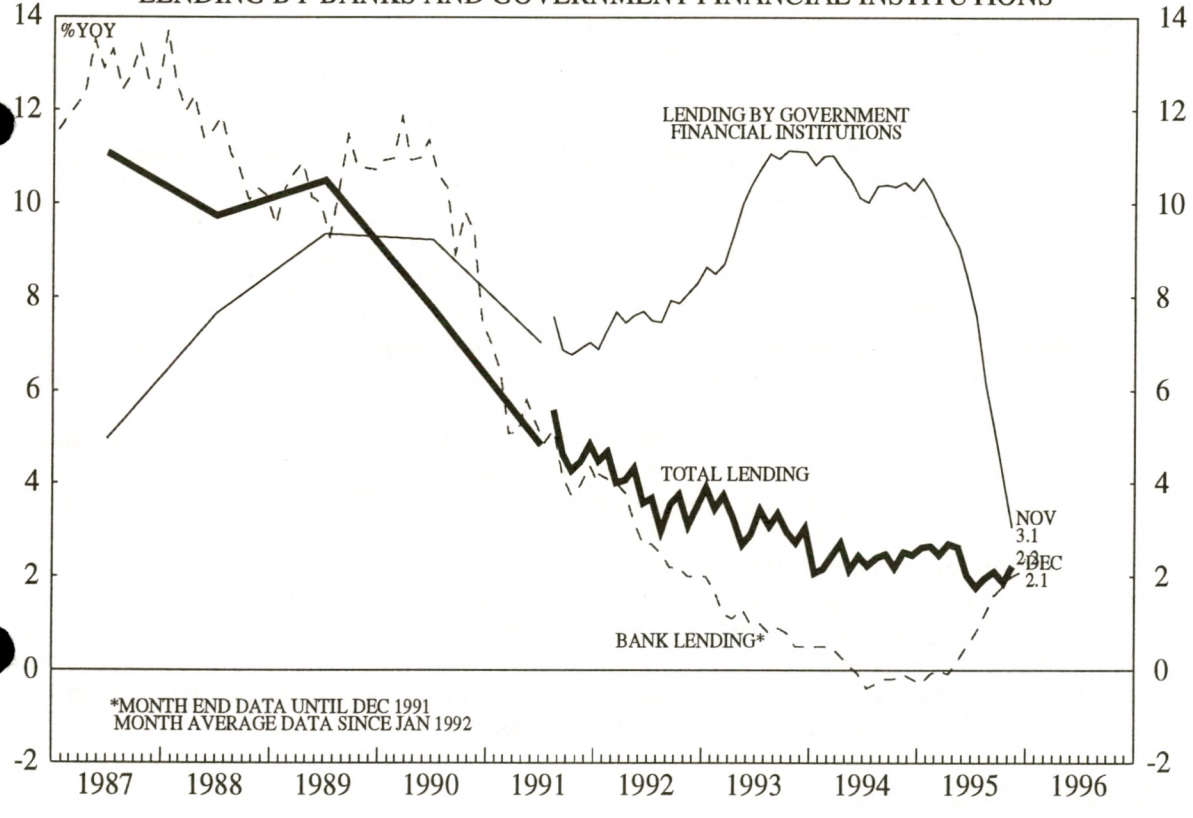
Several commentators have pointed to explosive growth in liquidity injections by the BoJ. Chart 4 shows that domestic credit from the monetary authorities (BoJ plus parts of the Ministry of Finance) did accelerate significantly in the second half of 1994 and first half of 1995, but has since fallen back to negligible growth rates. Meanwhile, total domestic credit (of the whole monetary system) has only accelerated modestly to 2.3% year-on-year growth. In other words, injections of liquidity by the monetary authorities have not led to proportionate increases in overall domestic credit. The decline in the degree of intermediation and credit expansion of Japan's commercial banks is more clearly illustrated in the loans-to-deposits ratio and the credit multiplier shown in chart 5. To smoothe out the volatility and seasonality we have used 12 month moving averages, which show more clearly the secular down-trend in the credit multiplier and the cyclical downtrend in the loans-to-deposits ratio. Given the bad-loan problems afflicting Japanese banks' at home and the 'Japan Premium' funding problems which have recently afflicted their overseas operations, their declining effectiveness as financial mediators and credit creators should not be that surprising. Until banks' balance-sheets are repaired, these problems will continue to drain the funding available to banks from deposits and central bank credit.

JAPAN: CHART 5
LOANS/DEPOSITS RATIO AND CREDIT MULTIPLIER



Japanese banks have finally resumed lending. However, the loan growth is still at a pretty anaemic year-on-year growth rate of only 2.2% in January, with domestic yen-denominated loans growing at an even less impressive 1.1%. Moreover, within the context of total lending by both banks and government financial institutions, it is clear that the increase in bank lending has coincided with a marked slowdown in lending by government financial institutions. Whereas government financial institutions have been reluctant to lower their interest rates below the rate of return required for funds from the Trust Fund Bureau and the Fiscal Investment and Loans Programme, commercial banks have increased their market share in loans for housing and for small and medium-sized enterprises. However, the growth rate of total loans still appears to be on a declining trend.

JAPAN: CHART 6
LENDING BY BANKS AND GOVERNMENT FINANCIAL INSTITUTIONS



SUMMARY AND CONCLUSIONS: The rising liquidity preference of money demand and balance sheet repair and maintenance by Japanese banks has weakened the money and credit multipliers. Although the BoJ has adopted a more accommodative stance of monetary policy, this has so far merely injected enough liquidity to keep the banking system and the economy on life support. A solution to the rot of debt deflation is needed by means of more aggressive (rather than just accommodative) liquidity injections to prompt a sustainable expansion of banks' balance sheets and of the economy. Such liquidity injections would probably involve an abandonment of nominal interest rate targeting, more aggressive open market operations leading to a significant rise in banks' excess reserves, and further weakening of the yen.

MALAYSIA
MONETARY POLICY TO TURN THE CORNER

Introduction

Macroeconomic concerns rise and fall in the eyes of policymakers even though they may remain unchanged for some time. In Malaysia the current account deficit is a case in point. It was clear from the monetary conditions in 1993-94 that the current account position would deteriorate in 1995. The external imbalances have persisted and been brought in and out of focus as the US$ has fluctuated against other OECD currencies. However, the external deficits and associated currency 'wobbles' are a reflection of the underlying monetary environment. As we have highlighted in past AMM issues, the monetary environment itself has become much more expansionary in the 1990s. This stems from the way the current administration chose to deal with the tremendous influx of foreign capital in 1992-93. Instead of the currency being permitted to appreciate relatively unhindered, it has been heavily managed.

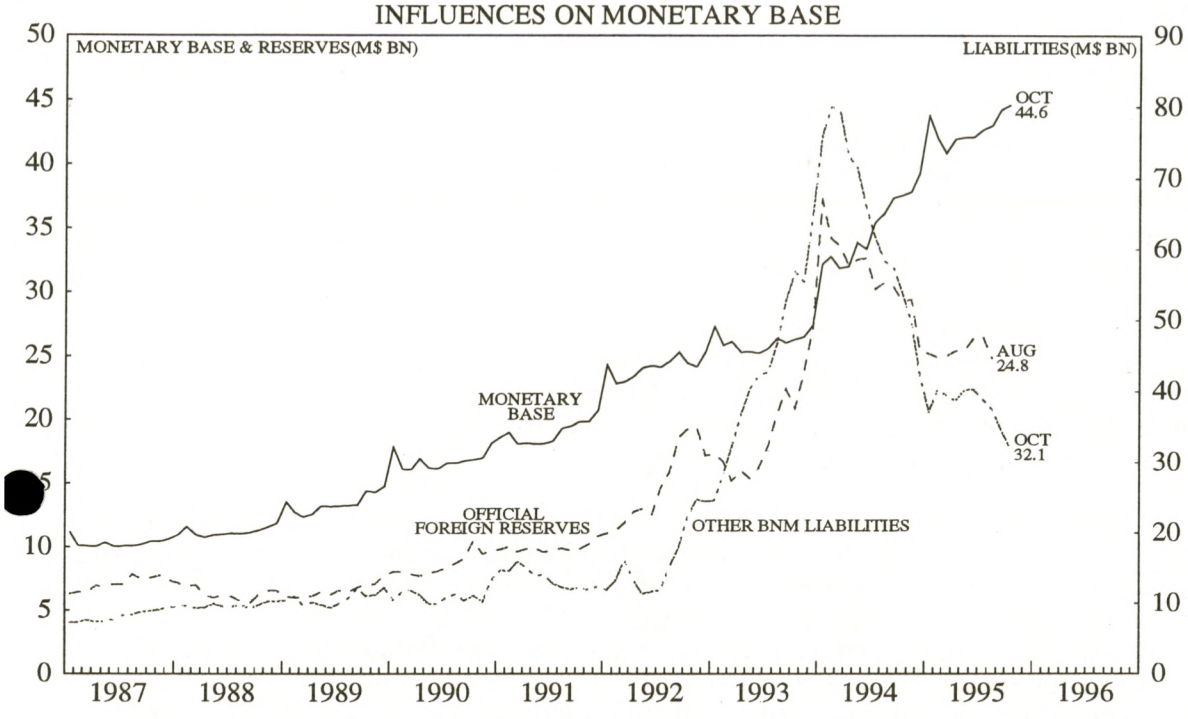
As long as the authorities continue to pursue a 'dirty float,' currency policy, there will be a monetary adjustment which will create fluctuations in aggregate demand in response to the balance of payments condition. Last year the 'unexpectedly' high amplitude of the cycle in credit caused the authorities to reach for certain potions from the medicine cabinet in much the same way that the Taiwanese did in 1989. In this article we consider these and what will turn out to be the most effective among them: the reserve requirement ratio. This tool is a blunt method of restricting the money supply and if used more extensively will lead to (1) higher interest rates and (2) a widening in bank's interest rate spreads.

The use of yet higher reserve requirements could well be the shape of things to come this year. This would be consistent with both stronger capital inflows (and upward pressure on the M$/US$) or periodic capital outflows (bringing M$/US$ weakness). Consequently, we can expect additional interest rate rises. Monetary conditions would become less easy -- tightening later in 1996 as banks respond to higher interest rates. As a result the growth of the monetary aggregates would moderate later this year accompanied by a decline in credit demand. This would not be a comfortable time for local banks or for the stockmarket especially after the large expansion in credit volumes in 1995. However, after the forthcoming interest rate rises, additional equity gains should start to become more sustainable as the pace of economic growth declines.

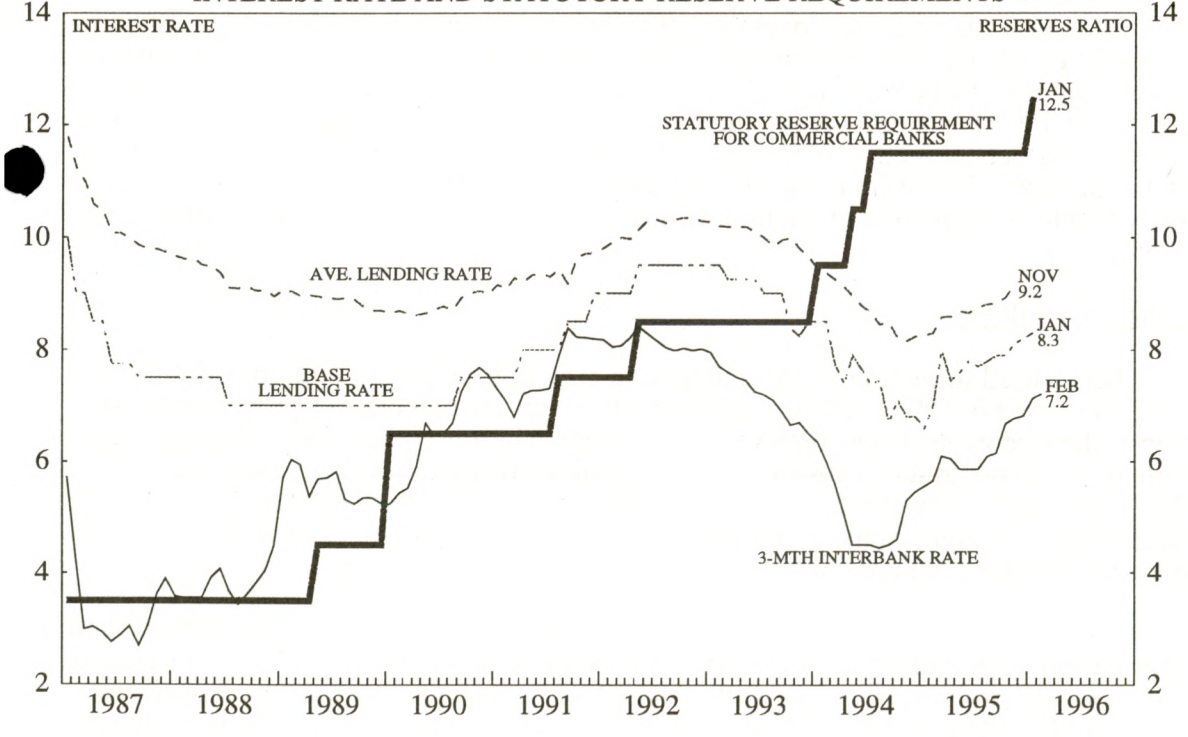
Recent monetary trends

Like many of its neighbours, since the early 1990s Malaysia has seen a substantial rise in the foreign capital entering the economy. The policy of stabilising the exchange rate pursued by BNM in 1993 created a large monetary expansion which some time later has caused the trade accounts to deteriorate. The first stage in this process was the substantial pickup in official foreign exchange reserves over 1992-93. However, the expansionary effect of this on the monetary base was neutralised to some degree by offsetting operations. This is illustrated in chart 1 by the 'mountain' of Other Liabilities created by the central bank, Bank Negara Malaysia (BNM). BNM created these extra liabilities to mop up newly created loanable funds held by commercial banks. In creating these liabilities, BNM has incurred an interest rate cost -- derived from the difference between the interest received on their foreign exchange assets and that paid on BNM bills -- which is ultimately passed on to the government in the form of lower BNM earnings. This might appear to be the 'price' of stabilising the exchange rate in these conditions, but is it ?

MALAYSIA: CHART 1
INFLUENCES ON MONETARY BASE



MALAYSIA: CHART 2
INTEREST RATE AND STATUTORY RESERVE REQUIREMENTS



The story does not end here. During 1994 while US rates were rising, Malaysia experienced capital outflows. The stock of foreign exchange reserves declined and BNM smoothed the rise in local interest rates by not renewing some of its Other Liabilities. Consequently, the outstanding stock of BNM's Other Liabilities declined in line with official foreign exchange reserves. However, also in 1994, the growth rate of all the monetary aggregates slowed in line with the depletion in foreign exchange reserves. Nevertheless, the banking system remained flush with short term loanable funds even though credit demand remained weak. During 1994 the banking system was so 'liquid' that BNM raised reserve requirements by 3% to 11.5% ; an instrument that had not been used since the previous clampdown in credit in 1992 (Chart 2).

In 1995, BNM continued to unwind its stock of Other Liabilities and the level of the monetary base continued to rise, although this was partly offset by further declines in foreign exchange reserves. The demand for bank credit, which had been slack in 1994 picked up strongly in 1995. Chart 3 shows these trends in the monetary base, bank credit and M3 in the form of the accumulated annual changes.

By the end of 1995, interest rates had risen by around 2% from their trough in 1994. However the relative stability in the currency implied that this merely reflected the earlier hikes in US rates rather than BNM action to tighten monetary policy (chart 4). The accommodative stance of monetary policy throughout 1995, meant that banks were in a very good position to expand their loan books aggressively, notwithstanding the earlier hikes in reserve requirements. This shows up clearly in chart 5 which illustrates the changes in commercial banks assets. The rundown in bank's short term assets held at BNM, included in 'amounts due to other banks,' has fed through to a dramatic expansion in Malaysian securities, overdrafts, advances and other term loans.

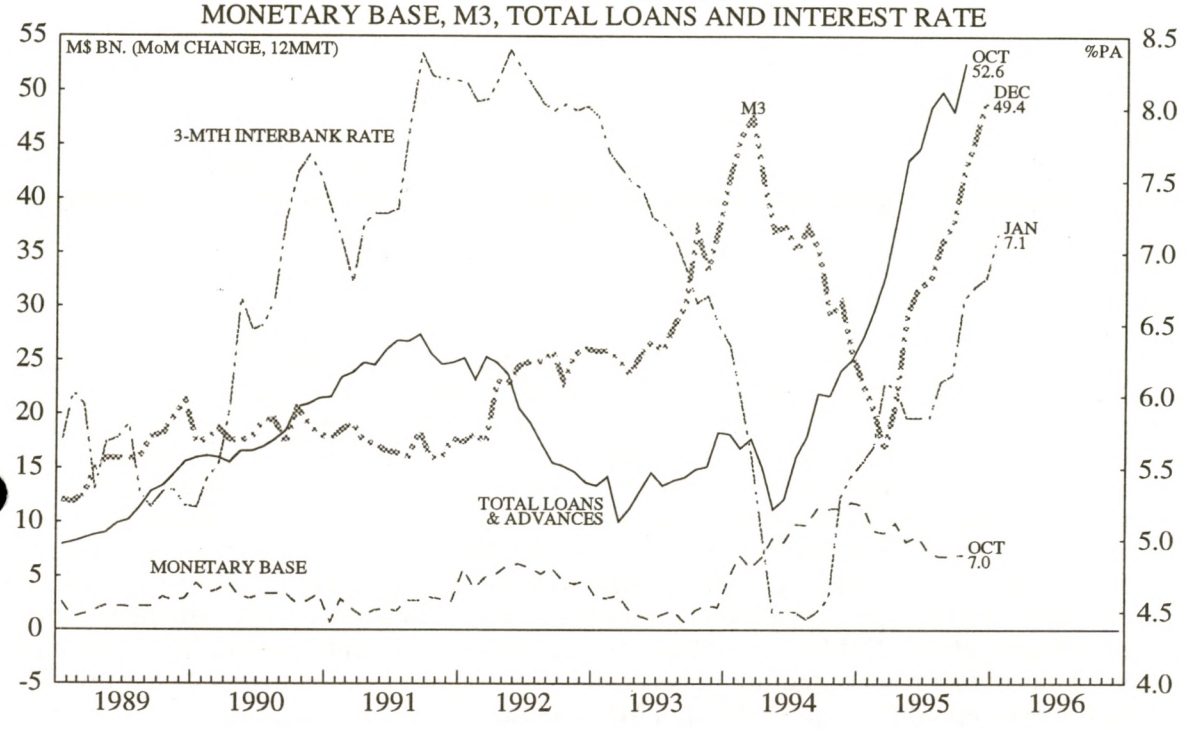
The magnitude of the upswing in credit has prompted the authorities to introduce a few credit restraints since the November 1995 budget. These included demand-side restrictions such as: raising the minimum credit card payment from 10% to 15% and a reduction in motor vehicle financing from 80% to 75%. In addition, BNM was forced to raise interest rates by 50-100bp in late October/early November as the M$ came under strong downward pressure. Further action took place again in late January. Once again as the M$ came under intense downward pressure BNM raised interest rates by 20-30bp and brought in the more heavy handed supply-side restriction. It raised reserve requirements by a further 1% to 12.5%.

Monetary Outlook

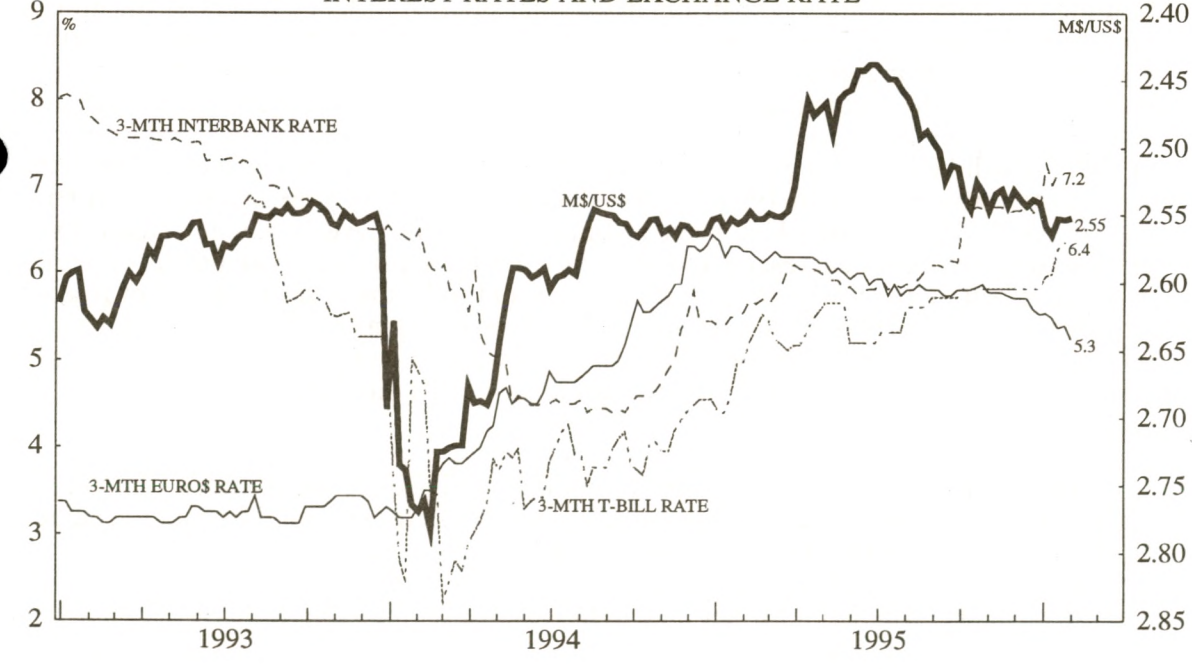
BNM tried to neutralise the stimulative effect of the huge build up in foreign exchange reserves in 1993. In their exchange rate policy framework this proved impossible even as the foreign exchange reserves were run down in subsequent years. The banks have been more 'liquid' and in a position to grant credit more aggressively to the private sector. They have finally done this as credit demand has grown in 1995. A key lesson from this is that sterilised foreign exchange intervention only delays the ultimate transmission of the monetary impetus, but does not negate it.

As a result, the economy continues to grow vigorously and there is upward pressure on price and wages inflation. Although this appears largely absent from the CPI statistics, other potential proxies such as the PPI or manufacturing unit labour costs have accelerated (Chart 6). It is this inflationary pressure that is the ultimate 'price' of the managed ex-

MALAYSIA: CHART 3
MONETARY BASE, M3, TOTAL LOANS AND INTEREST RATE



MALAYSIA: CHART 4
INTEREST RATES AND EXCHANGE RATE



change rate policy pursued by the authorities and not, as some have suggested, the fiscal cost of sterilisation mentioned earlier.

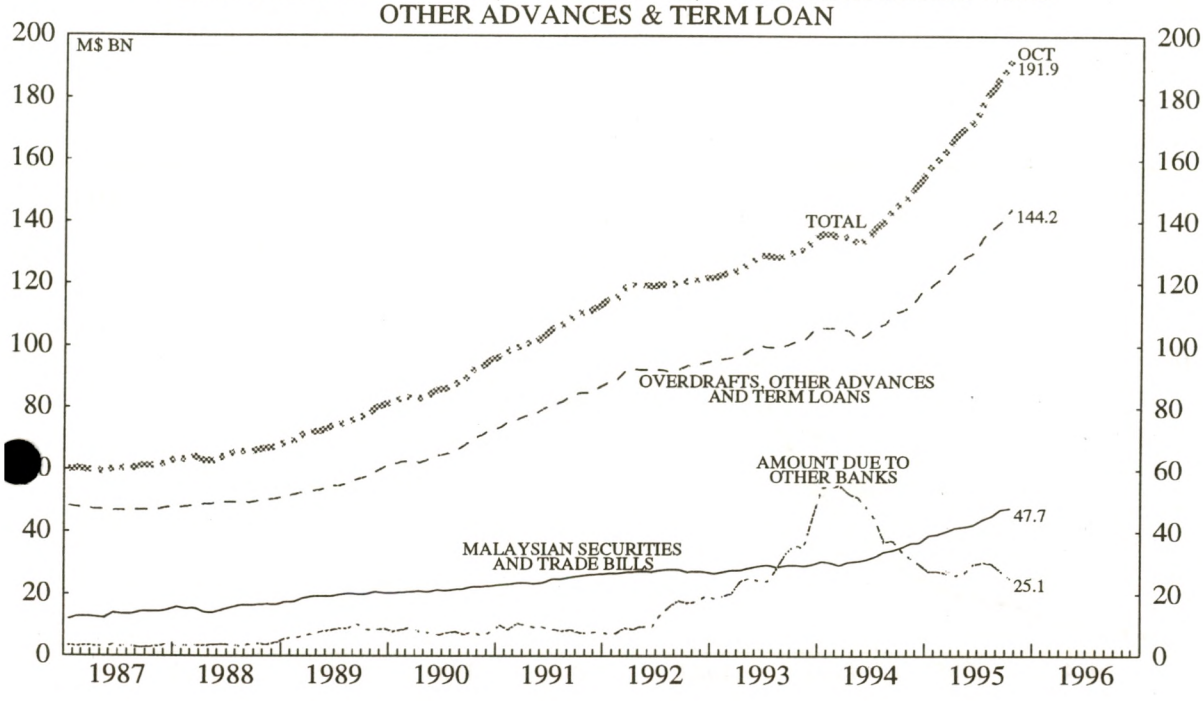
One of the features of the monetary policy stance adopted by BNM is that it has been passive and retroactive. It appears that it has waited until the the foreign exchange markets have sold the M$ more intensively, before acting to shore up rates. In this way the foreign exchange market -- reacting to external imbalances -- has cajolled BNM to notch up on-shore rates. What is interesting and significant about their latest response is the comparatively prompt hike in reserve requirements. This may not have been strictly necessary to stabilise the currency turbulence. Therefore it is mildly surprising given the customary tendency for BNM to drag its feet over monetary policy tightening.

Looking ahead over 1996, BNM could take further restraining action on monetary policy if the M$/US$ encounters additional currency weakness in the spot foreign exchange markets. In this event higher reserve ratios are an option which will have increasingly greater restraining influence over the expanding money supply and its overheating symptoms. Alternatively, it is possible that the foreign capital flows reverse direction as foreign portfolio investors increase their holdings of Malaysian assets. This could place upward pressure on the M$/US$. Once again BNM would seek to stabilise the currency movements. Because credit growth is currently very strong, higher reserve requirements would appear to be appropriate to (1) reduce credit growth and (2) offset any newly created M$ deposits by BNM as it purchases foreign currency to "cap" the M$/US$ appreciation. Thus higher reserve requirements are a likely course of action irrespective of which way foreign capital flows push the spot M$/US$ rate.

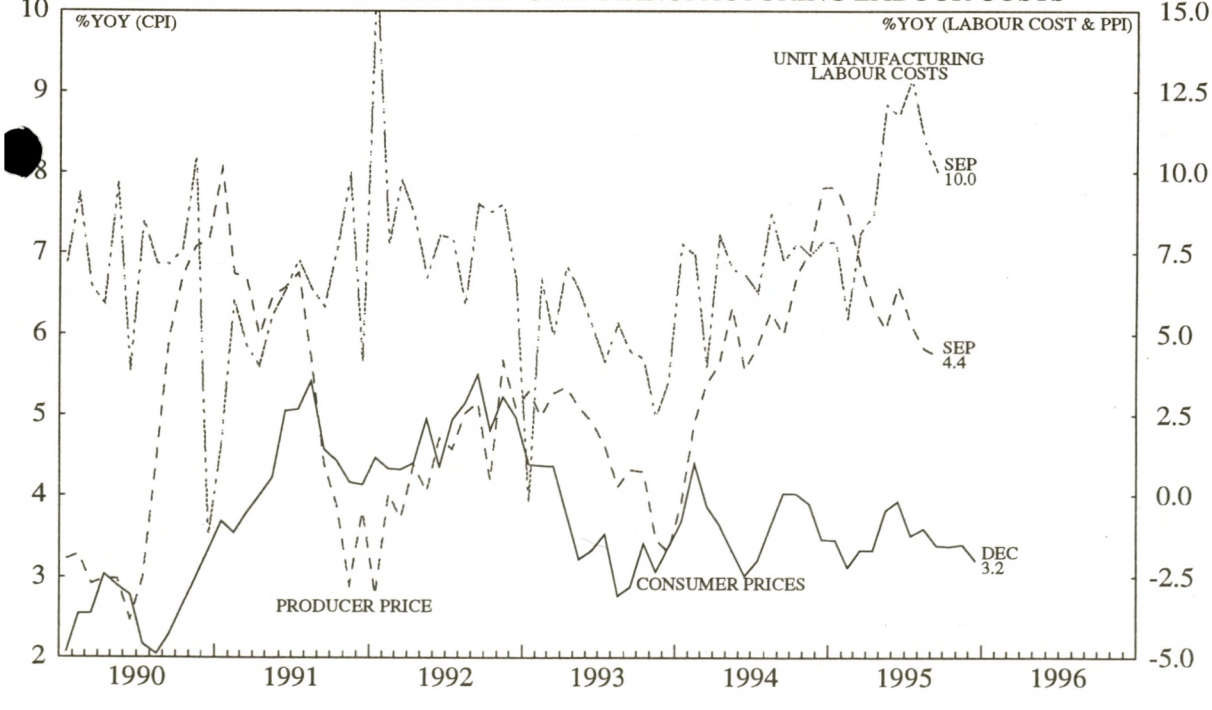
A reserve requirement hike is effectively absorbing some of the short term assets currently held by the banks in the form of deposits at BNM or BNM bills. By locking away a greater portion of potentially loanable funds BNM is doing three things. Firstly, it is limiting the ultimate (future) expansion in the total stock of M3, or conversely the money multiplier declines. Secondly, it is reducing the 'cushion' of short term assets that gives bank's interest rate margins some short term protection against higher funding costs. The pricing of new bank lending will become more sensitive to and should reflect to a greater degree each future hike in deposit rates. Consequently, each time BNM raises interest rates in 1996, it will be having a greater influence on raising the marginal cost of credit in the system than was the case in 1994-95. As is visible from chart 5 the stock of short term asssets held by banks at BNM has been declining in line with the expansion in credit. Even in the absence of the recent reserve requirement hike, the sensitivity to higher deposit rates is rising, albeit more slowly. Finally, if this turns out to be the first of a series of reserve requirement rises in 1996-97, then increasingly, interest margins will have to rise and banks will find ways to evade this requirement ratio. This would entail seeking to collect funds in some other non-reservable way or try to earn more profits through fee based off-balance sheet activities.

Despite the recent rise in reserve requirements and rises in interest rates, it is still too early to descibe monetary conditions as being 'tight'-less loose would be more accurate. However, the outlook has changed. The demand for credit at prevailing rates is clearly very strong and will at some stage run up against the restraints currently being placed on monetary deposits growth. Each further hike in the reserve requirement ratio risks causing an unexpectedly high increase in interest rates as banks will find themselves being caught short, having to scramble for funds. This is the signal that indicates tighter monetary policy is in place and credit growth will then definitely slow. Until this time interest rates will likely creep upwards slowly while BNM waits for downward pressure on the M$/US$ to inten-

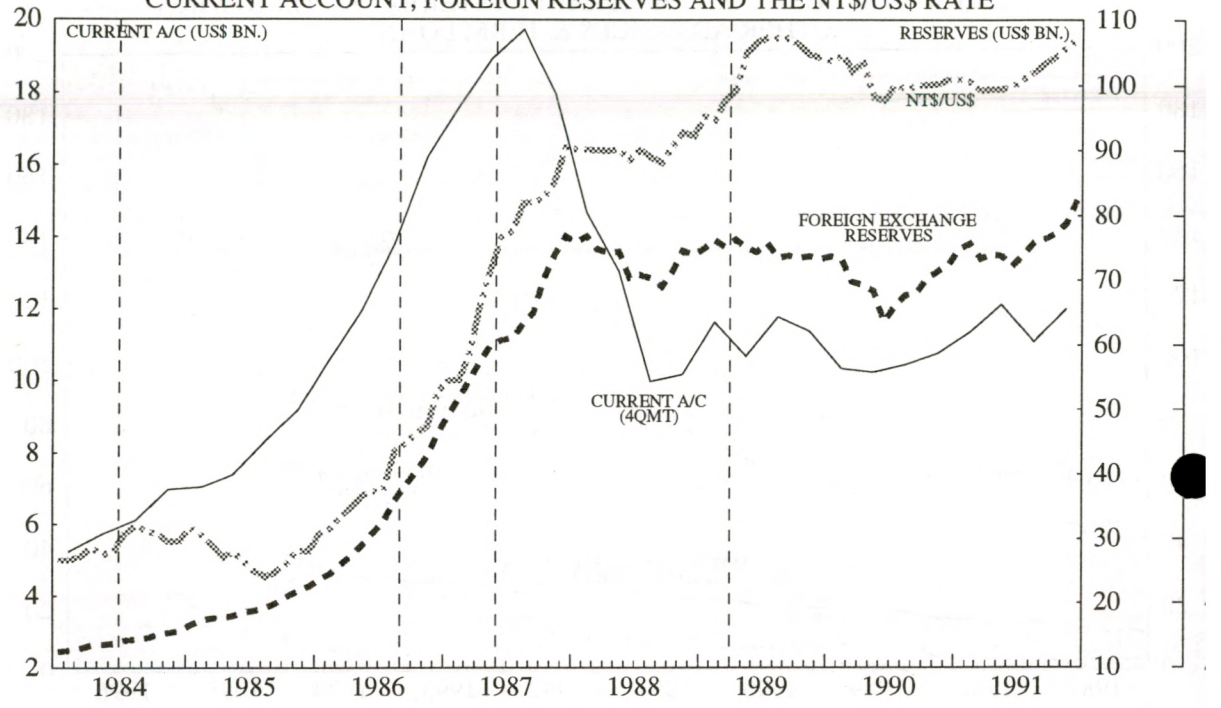
MALAYSIA: CHART 5
MALAYSIAN SECURITIES, OVERDRAFTS, INTERBANK BORROWING
OTHER ADVANCES & TERM LOAN



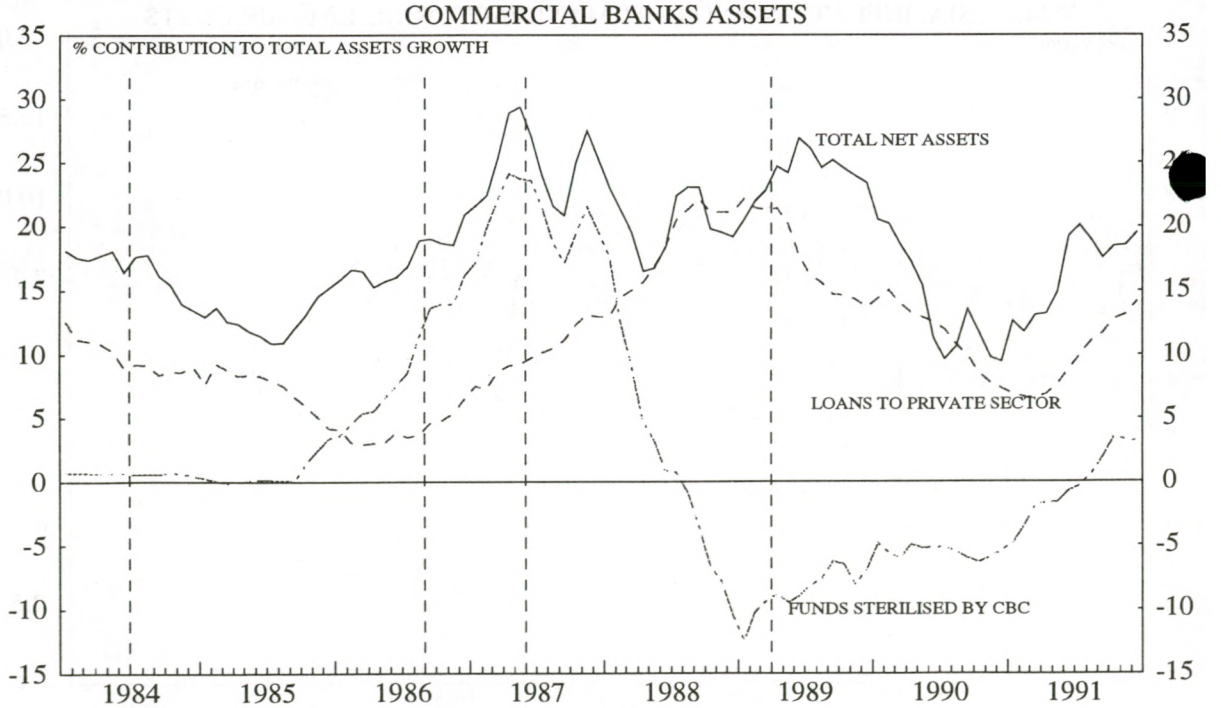
MALAYSIA: CHART 6
MALAYSIA: INFLATION AND UNIT MANUFACTURING LABOUR COSTS



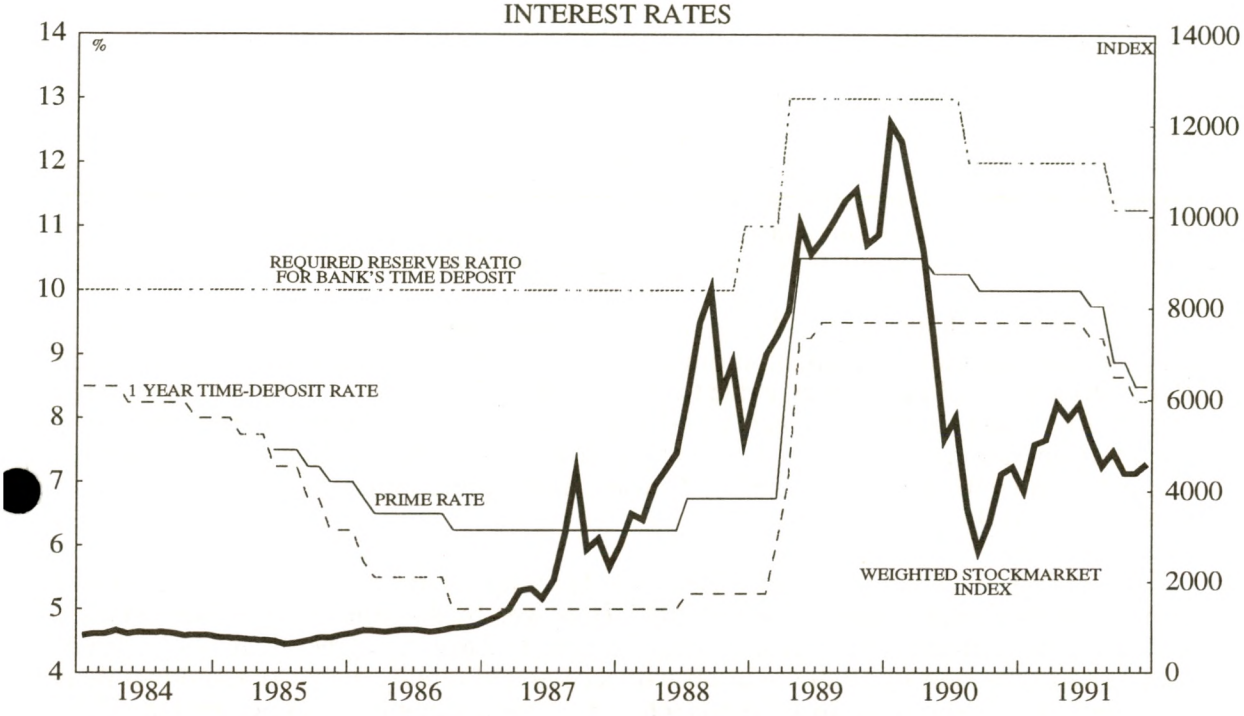
TAIWAN: CHART 7
CURRENT ACCOUNT, FOREIGN RESERVES AND THE NT$/US$ RATE



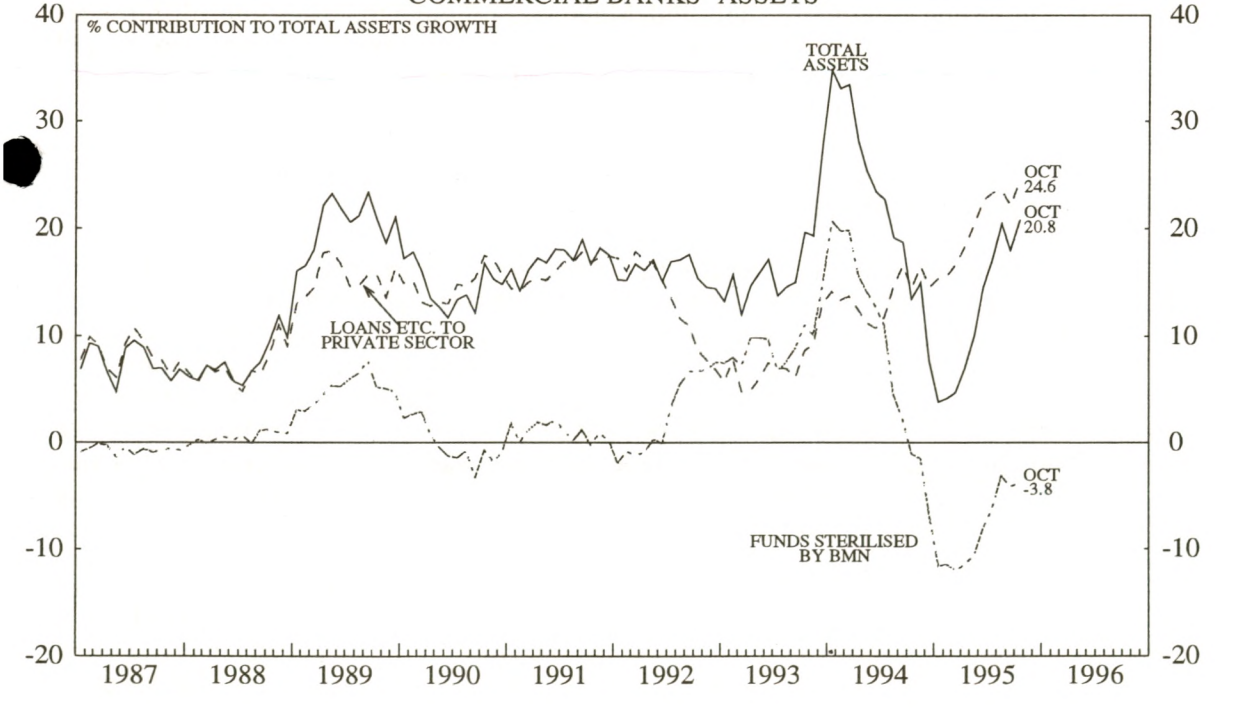
TAIWAN: CHART 8
COMMERCIAL BANKS ASSETS



TAIWAN: CHART 9
INTEREST RATES



MALAYSIA: CHART 10
COMMERCIAL BANKS' ASSETS



sify before tightening monetary policy further.

An Analogy with Taiwan

In a previous issue of AMM (Nov-Dec 1993 Vol.17 No.6) an analogy was drawn between Taiwan and Malaysia in the way the respective central banks dealt with extremely positive balance of payments positions. Both conducted significant sterilised foreign exchange intervention to limit the appreciation in their currencies. As a result they both inherited similar symptoms of monetary indigestion as the expansionary effects of the foreign exchange reserves accumulation passed through the system.

To begin with, the accumulation of foreign exchange reserves in Taiwan was generated by a strong current account surplus. The central bank, the Central Bank of China (CBC) tried to 'cap' the exchange rate from mid 1984-86 (see chart 7). This brought huge stockmarket and property price gains which lasted till mid-1989. However, the CBC sterilised this operation, so while broad monetary growth and total banking assets expanded, credit demand remained weak (chart 8). Consequently, interest rates declined to a trough in 1986-87 (chart 9).

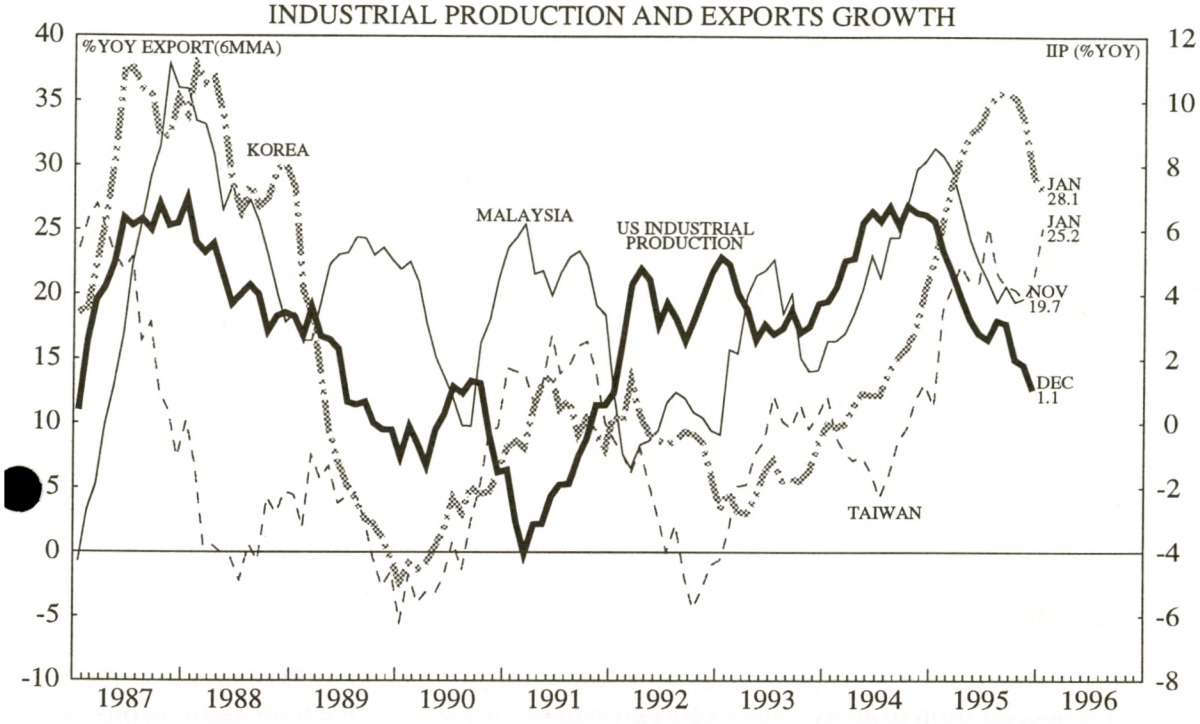
The CBC eventually gave in to the upward pressure on the currency and the sterilisation policy then came to an end by mid-1987. However, by that time, the low interest rates had raised the demand for credit and banks were primed to expand their loan books. From mid-1987 to the start of 1989 credit growth accelerated rapidly as banks ran down their 'cushion' of previously sterilised funds (chart 8). This lending boom concerned the CBC when CPI inflation accelerated in 1989 and as the trade surplus declined. In early 1989 the CBC raised reserve requirements and interest rates abruptly. Shortly afterwards, the growth of bank credit and total assets decelerated (charts 8 and 9).

There are some striking parallels with Malaysia, although there are some differences too. The key similarities are: (1) the build up in Taiwanese foreign exchange reserves and initial decline in interest rates, (2) the rise in the sterilised assets of the commercial banks alongside the expansion in total banks assets (Chart 10), (3) the 'unwinding' of the sterilised instruments giving way to faster loans growth (compare Charts 8 and 10) and (4) the credit expansion emerging as a concern, which coupled with inflation and/or trade account fears prompt tighter monetary policy.

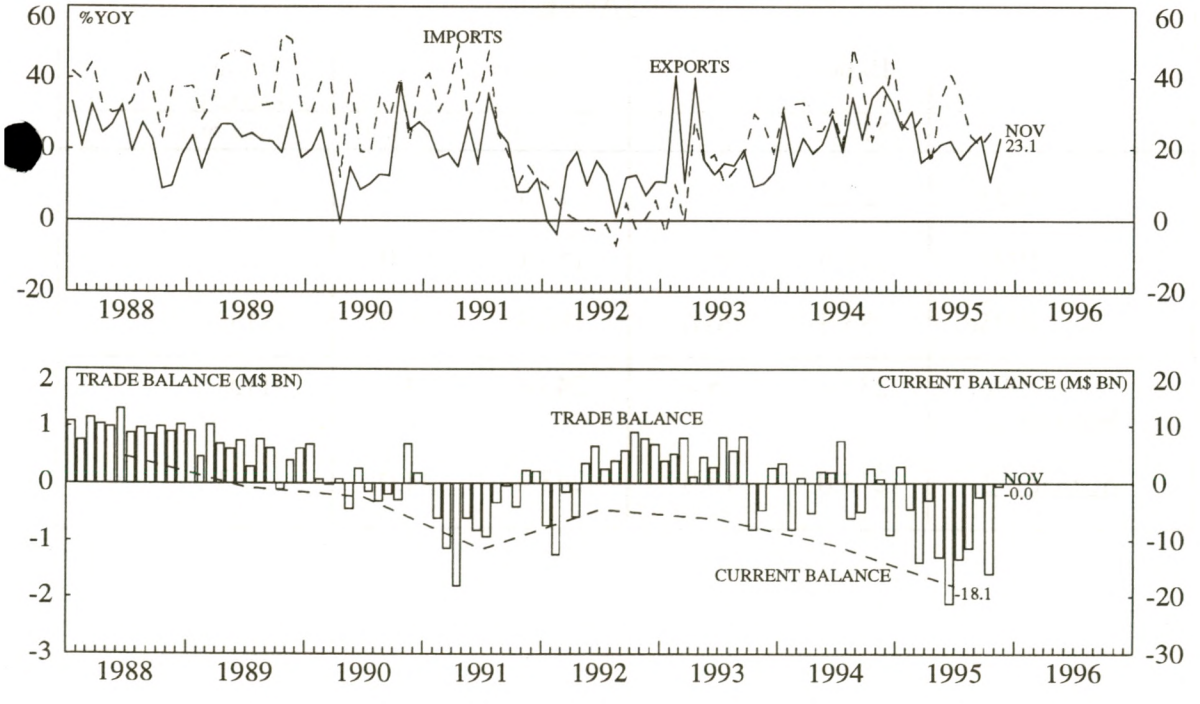
Major differences are: (1) that the Taiwanese equity market continued to rally well after the interest rate hike, although it 'bounced' almost 100% after the 1990 crash, (2) that Taiwan's CPI inflation rate actually accelerated while in Malaysia it has remained stable, (3) Taiwan had another "instrument" of monetary policy: capital account restrictions. The capital controls prevented the tighter monetary policy from attracting foreign capital flows. Finally, (4) the CBC tightened monetary policy at a time when the level of foreign exchange reserves was fairly stable, although the trade surplus looked more vulnerable. This was because export growth decelerated almost a year before import growth in response to the economic slowdown in the US in 1988.

Given the controls on the components in the CPI and hence the repressed nature of the CPI in Malaysia, the trade account may continue to be the lead indicator for further monetary tightening. This may set in motion private capital movements which could bring about further depletion in the official foreign exchange reserves position. The final section considers the outlook for the external balances in 1996.

CHART 11
INDUSTRIAL PRODUCTION AND EXPORTS GROWTH



MALAYSIA: CHART 12
MALAYSIA: TRADE PERFORMANCE



Current Account Balance Outlook

Just as the authorities were keen to 'cap' the rise in the M$ in 1993, so they have acted to support their currency over the past two years as it has come under downward pressure from the negative balance of payments condition. As explained earlier, the trade and current account deterioration in 1995 has appeared as a natural consequence of the huge inflows of capital in 1992-93.

Up to now the main driving force behind the trade deterioration has been the strength in import demand. Some are expecting this to improve as credit conditions tighten up. However, export growth is also a key consideration. One can observe how rapidly export growth can decline due to slumps in major export markets. This occurred in Taiwan and Korea in 1988 when growth in the US began to slow (chart 11). Although the export base of Malaysia is more diversified than it was ten years ago it is still vulnerable to a slowing in US demand. The combination of very strong domestic demand with further sluggishness in external demand and exports will likely prolong the trade deficit, possibly causing it to widen further before it improves (chart 12). This in turn, has negative implications for the current account deficit.

In a brief attempt to examine the sensitivity of the trade position to export changes we have constructed two scenarios below. The table below gives the trade deficit figures to date and two scenarios for 1996. In the first, the average annual export growth required to at least stabilise the trade deficit is 25% (of similar magnitude to import growth). In the second, a deceleration to an average export growth of 15% widens the trade deficit considerably. Both scenarios assume the same minor deceleration in imports to an average of 24% p.a.

TABLE

	Exports		Imports		Trade Deficit
	M$ bn	% p.a.	M$ bn	% p.a.	(M$ bn)
1993	121.2	-	117.5	-	+3.7
1994	153.6	26.7	155.1	32.0	-1.5
1995e	185.3	20.6	196.3	26.5	-11.0
1996					
Scenario 1	232.4	25.4	243.4	24.0	-11.0
Scenario 2	213.0	15.0	243.4	24.0	-30.3

SUMMARY AND CONCLUSIONS: The trade and current account deficits have been deteriorating over 1995 and periodic bouts of weakness in the M$/US$ rate have triggered a depletion in official foreign exchange reserves. BNM's reaction so far has been to raise interest rates in a steady stepwise fashion just sufficient to roll back the currency pressures. The recent rise in reserve requirements was largely unexpected. Further rises would be likely to have a more significant impact on restraining money supply growth. At present because loan growth is so strong and because all eyes are focussed on the foreign exchange reserves, the reserve ratio hike is not regarded as a factor that will push up rates further. However, at some stage in 1996, credit growth will meet a balance sheet constraint and banks will begin to scramble for funds. At this point, further interest rate rises by BNM will have a much greater effect on bank's loan pricing and profitability. The subsequent slowing in credit and economic activity will then remove the current account 'thundercloud' which still hangs over the currency in the form of a risk premium and the stockmarket.

Until that time, rates will likely continue to creep upwards as BNM continues to protect against further depletion of its foreign exchange reserves. Additional outflows of foreign capital are possible as the trade deficit widens and the M$/US$ weakens. Further trade deterioration would primarily be due to a combination of strong domestic demand and weakening external demand, particularly in the US.

The point at which credit will become tight could be pushed further out in 1996 by a reflux of foreign capital back into Malaysian assets. However, in this event BNM could raise reserve requirements further, laying the foundations for tighter monetary policy further ahead.

TAIWAN
THE ELUSIVE NATURE OF MONETARY EASING

Taiwan's economy has been in the midst of a gradual slowdown since early 1995 which stems partly from the continued deceleration in monetary growth but also depressed domestic and external demand. M2 growth sank to 8.5% in December while industrial production has fallen from its peak of 10.3% yoy growth in February to contract by 0.6% yoy in December. Export growth, which accelerated sharply over 1994, reached a peak in 1995Q1. Its deceleration since then has contributed further to steady erosion of the current account surplus since early 1992 (see Chart 1). In an effort to rejuvenate domestic demand and stimulate consumer confidence, the Central Bank of China (CBC) embarked on a program of monetary expansion in late 1995 while the government has announced a massive rise in fiscal expenditures over FY97 . The equity markets greeted CBC moves with some cheer although it remains to be seen whether these efforts alone will be sufficient to entice back the consumer and investor, against the backdrop of rising unemployment, political tensions across the Taiwan Straits, and overall financial fragility.

In this article we track recent deceleration of M2 growth in Taiwan and examine its implications for economic growth in 1996 and afterwards. To begin with we take a look, from a somewhat theoretical perspective, at the process of monetary adjustment over the current cycle. An estimate is made of the sustainable rate of real economic growth, towards which the economy will naturally gravitate, given a stable velocity of circulation and an appropriate rate of inflation. We show that structural changes such as gently declining productivity growth over the past five years, and dwindling labour force growth, have probably lowered the level of sustainable growth, from a long-run trend of around 8.4% per annum, to between 6-7% in the early 1990s. Following an estimate of velocity growth and an assessment of its stability, we ask whether the inflation outlook is consistent with adjustment towards sustainable growth over time. The conclusion is that the recently announced target for M2 growth, between 9-14% in 1996 should be just sufficient to restore the real economy to its long-run growth track by late 1997, although growth will probably ease further in 1996 reflecting the current weakness of money supply growth. The uneviable challenge for the CBC, is to ensure that its monetary easing actually feeds through into M2 growth and real economic activity if the latter is not to fall well below trend. This objective may be seriously undermined in Taiwan by the acute sensitivity of capital flows to changes in domestic political and financial sentiment. From an investment perspective, it is likely that the demonstrated accuracy of the CBC's monetary management will once again leave little residual liquidity for the equity market.

The Sustainable Rate of Growth

High productivity growth has been an obvious characteristic of economic development in Taiwan since the 1970s with the service sector probably leading the way since the late 1980s. As with most rapidly developing economies the composition of the labour force has altered noticeably in favour of the service sector over the past twenty years. The proportion of the labour force employed in manufaturing has remained roughly static at 35% while its contribution to GDP has fallen by three percentage points to around 37%. In the meantime, the services sector has increased its contribution to GDP by 15% percentage points to almost 60% while increasing the percentage of the labour force employed by 15% percentage points to 50%. In an economy-wide context, what do these productivity and labour force trends together imply for the sustainable rate of economic expansion?

Table 1 below shows growth of manufacturing sector productivity and the labour force over a twenty year period from 1975 to 1994. The sum of these two factors is a ready approximation to the rate of real GDP growth (see Chart 2). Over the long run the sums indicate a sustainable growth rate of around 8.4%, although, if more recent productivity and demographic trends are projected, the slowdown in both of these factors since 1991 is indicating a lower figure, of perhaps 7%.

Table 1

Period Averages	Manufacturing Prod. Growth (% yoy)	Labour Force (% yoy)		Sustainable Real GDP (% yoy)
1975-1979	8.5	3.2		
1980-1984	3.4	2.8		
1985-1989	6.1	2.3		
1990-1994	5.6	1.6		
1975-1994	5.9	+2.5	=	8.4 (Actual = 8.9%)
1991	9.6	1.7		
1992	3.8	2.3		
1993	3.2	1.2		
1994	3.7	2.3		
1991-1994	5.1	+1.9	=	7.0 (Actual = 6.8%)

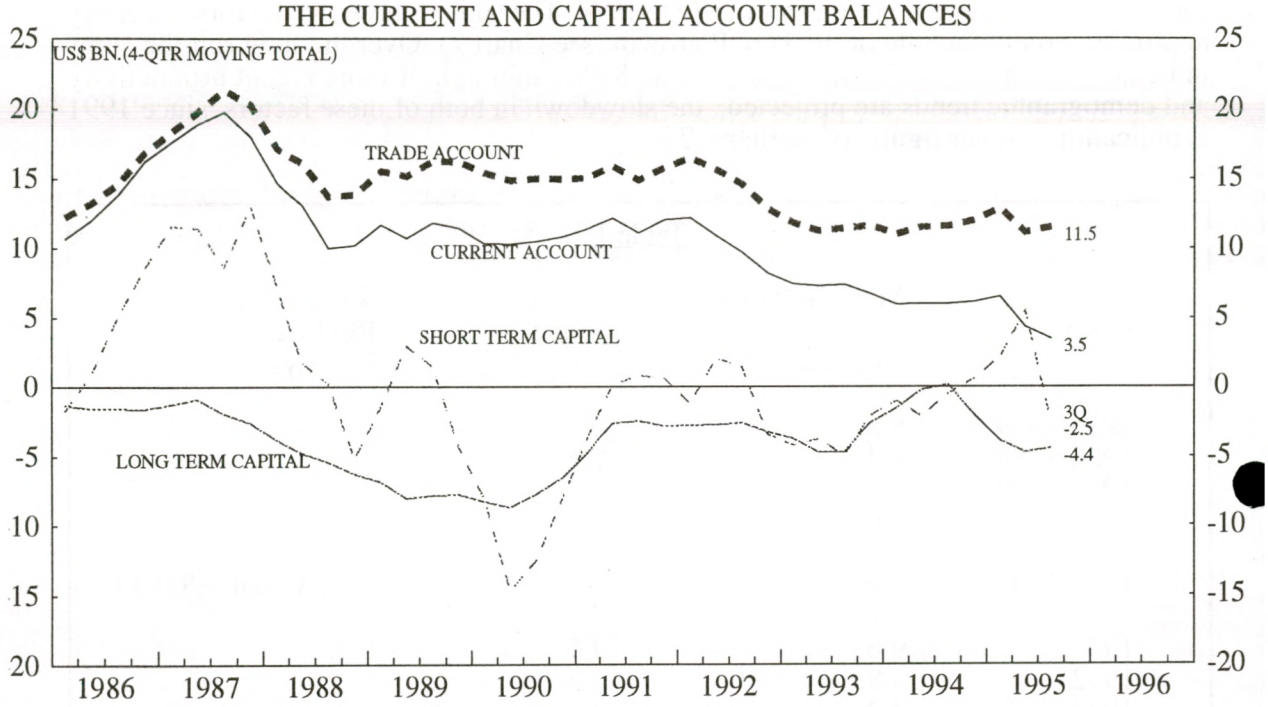
Source: Industry of Free China (CEPD)

No published data are available for growth in total labour force productivity although in practice manufacturing sector productivity is a good average approximation for the economy as a whole. As changes in the composition of employment partly suggest, service sector productivity growth has, undoubtedly, been higher since 1975 although not much more so than in the manufacturing sector if, for instance, measured in terms of relative nominal wage growth. In any event, real GDP in Taiwan has grown on average by 8.9% since 1962Q1, sufficiently close to our own long-term growth estimate of 8.4%. Notwithstanding such mild statistical abberations and taking more recent trends into account, we argue that the sustainable rate of growth has moved substantially lower in the past five years to perhaps 7%. It is quite likely then that the economy has been operating at very near, or just marginally below, its potential rate for the past four years and it remains to be seen whether monetary developments have been consistent with the continuation of this trend.

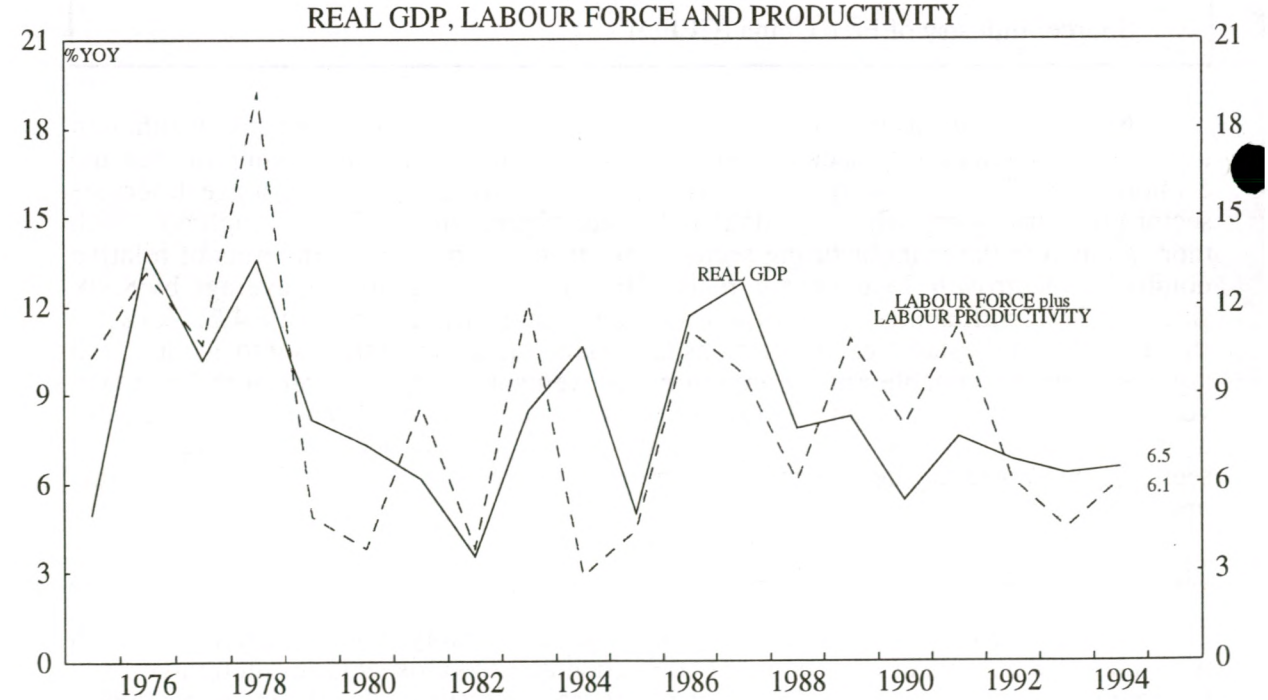
Measuring Long Run Velocity of Money

Monetary theory suggests that inflation which inevitably follows monetary growth with a lag will also ensure that nominal GDP gravitates towards its long-run trend during the course of a monetary cycle. This adjustment process assumes that the income velocity of money remains broadly stable over time. The assumption of stable velocity can be partly

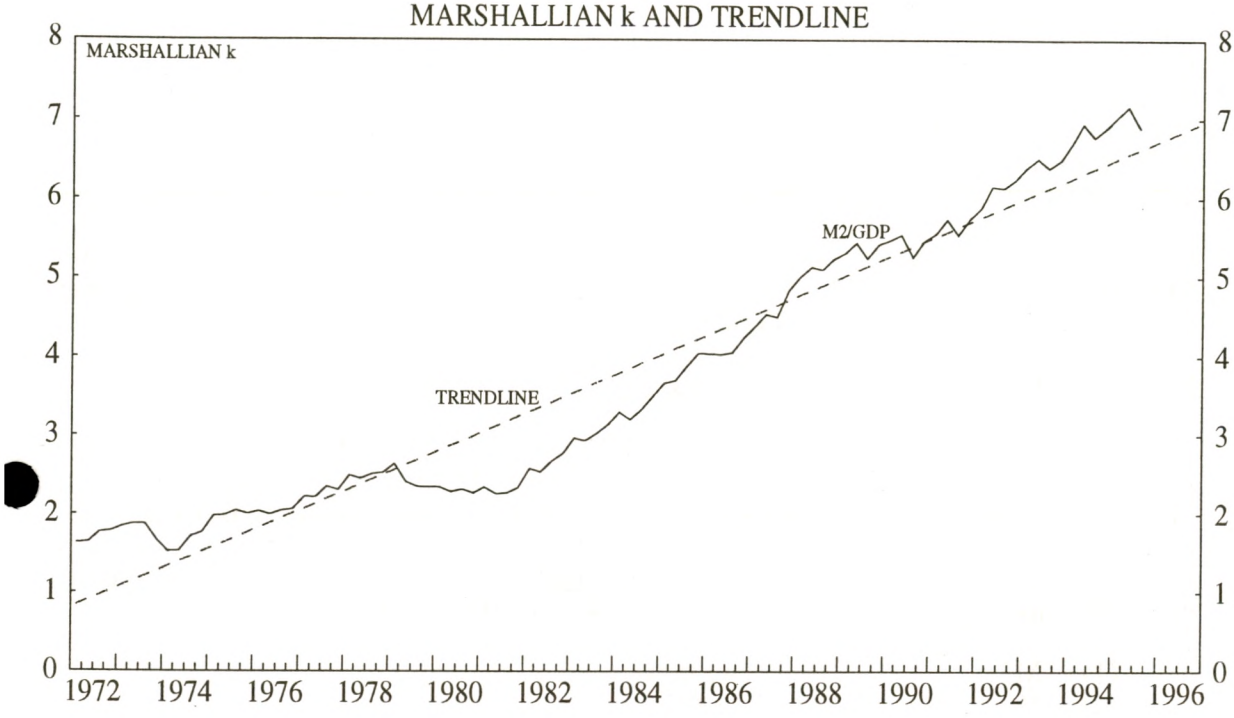
TAIWAN: CHART 1
THE CURRENT AND CAPITAL ACCOUNT BALANCES



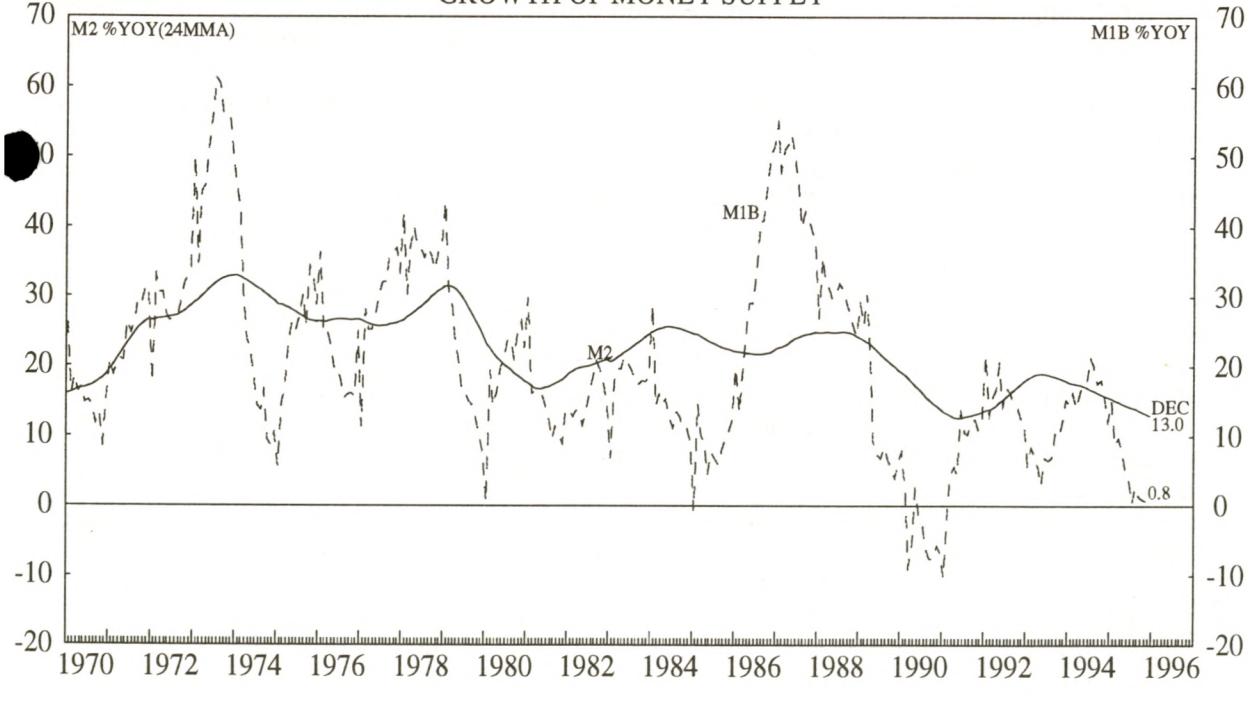
TAIWAN: CHART 2
REAL GDP, LABOUR FORCE AND PRODUCTIVITY



TAIWAN: CHART 3
MARSHALLIAN k AND TRENDLINE



TAIWAN: CHART 4
GROWTH OF MONEY SUPPLY



tested by observing the behaviour of the broad money stock (M2) relative to nominal GDP as in Chart 3. The graphic illustration of this relationship shown by Marshallian k (Mk) which measures the reciprocal of velocity, or the ratio of the M2 stock to actual nominal GDP, displays considerable deviation about its long-run trend for prolonged periods. It is difficult to discern precisely whether such deviations are attributable to temporary changes in the income velocity of money, or whether price adjustments to a monetary shock are both "long and variable". Nevertheless, while sizeable one-off velocity shifts may occur during the course of any given cycle, it is reasonable to assume that the average growth rate of velocity over time is likely to be broadly stable. The latter can be measured by the elasticity of the Mk(M2) trend line in Chart 3 at any given point, which at around 1995 Mk(M2) is rising by about 1.6% per annum (gradient=0.06); or alternatively the income velocity of M2 is declining by a similar amount each year.

Sufficient Money Growth but Little in Excess

Based on structural values for trend real GDP growth and for M2 velocity calculated above, the progress of the monetary cycle can be gauged by reference to a dynamic version of the familiar Fisher framework (M+V=P+Y, all variables expressed in %YoY changes). Assuming nominal GDP growth responds to average M2 growth over the past two years (Chart 4), the adjustment towards a sustainable real growth rate of around 7% is consistent with an average inflation rate of around 4.4%, as shown in the table below:

(1)	M2	=	+13.0%
(2)	V	=	-1.6%
(3)	GDP	=	+7.0%
Inflation (1+2-3)		=	+4.4%

The average inflation rate over the past two years has been steady at around 4% (Chart 5) suggesting that M2 growth has been well managed, if not somewhat on the tight side, to ensure steady recovery towards the long-term growth trend. Inflation should continue to ease sharply into early 1996 although higher import costs associated with a weaker currency will exert upward pressure on the inflation rate by year-end. From a financial market perspective, the numbers imply little liquidity growth at the margin for the benefit of equity markets. We will also show later that excess liquidity was probably spilling across the currency exchanges in 1995 weakening the NT$. Thus from its peaks in 1994 the Taiwan weighted index has fallen steadily despite a brief liquidity induced rally in December 1995 (see Chart 6).

Looking ahead to the end of 1996, a very substantial slowdown in nominal activity is in prospect if current M2 growth trends are allowed to persist (projecting current M2 trends yields an average growth rate for two years of 6.7% by end-1996). Hence the CBC has chosen to ease monetary conditions aggressively in the past three months. However, even importing the CBC's own objectives for M2 expansion of between 9-14% in the year ahead it is likely that the real growth will be weak. For instance, assuming M2 growth of 9% in 1996 (low end of the CBC target), giving a two-year average of 9-9.5%, and average inflation at 3.0%, then real growth may fall below 5%. More realisitically, M2 is likely to accelerate over the coming year (we forecast roughly 10% average growth for the year), to yield a two-year average around 10.5%. Real economic growth under these assumptions should fall to 6.0% by year-end, representing a mild slowdown in economic activity over 1995. Once again in 1996 it seems as if the accuracy and timing of CBC policy may be just sufficient to ensure sustainable growth although in that scenario, as in 1995, there is likely to be little residual money growth to fuel a sustained stock market rally.

The Prospects for Monetary Growth

The task ahead for the CBC is to bring about steady growth of private sector purchasing power by ensuring that monetary easing feeds as quickly as possible into M2 recovery without re-accelerating the inflation rate. Achieving the first objective against the backdrop of depressed consumer sentiment and wealth (as a result of the decline in both equity and property prices), and financial sector bad-debt problems will prove elusive, as recent Japanese experience has shown. The CBC needs to ensure that growth in banking sector assets in the preliminary stages of monetary easing eventually contributes to a permanent increase in private sector M2 balances. The obvious transmission channel for this would be through operation of the credit multiplier (essentially growth in bank credit), although, as shown in the table below, any success in this endeavour could be easily offset by a number of other factors.

The Table below shows the monetary sector (i.e. excluding the CBC) counterparts to M2 growth in the year to November 1995:

NT$ Millions

Approximate change in M2:	+975,661 (November 1994-November 1995)

Factors affecting Money Supply:

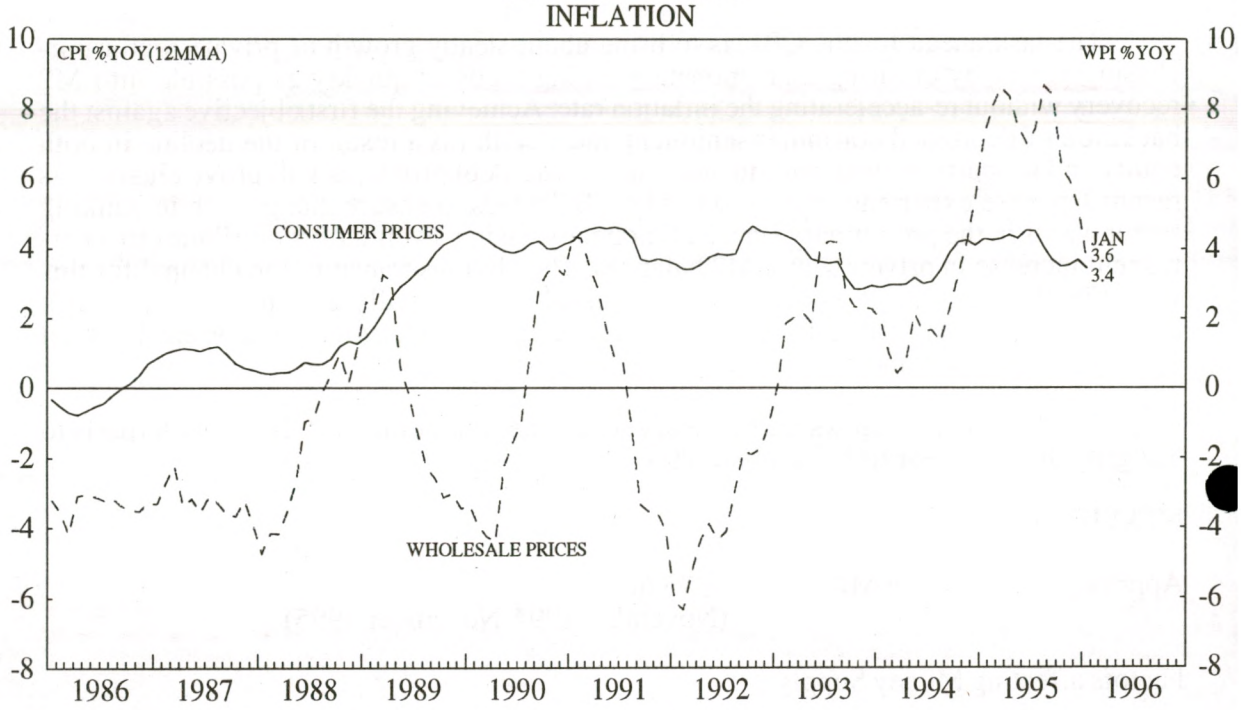
1. Lending to Private Sector	+930,350 (cf. +1,432,939 in 1994)
2. Net lending to Government	+191,287
3. Net Foreign Assets	- 86,819 (cf. +102, 669 in 1994)
4. Import Pre-settlements	+ 4,077
5. Other factors	- 63,234 (cf. -125, 338 in 1994)

Lending to the private has undoubtedly been very subdued (Chart 7) although a key factor depressing M2 growth would appear to be the unprecedented capital outflow, as represented in Chart 8 by the sharp fall in net foreign assets of the monetary sector (especially in August and September during China's naval manoeuvres in the Taiwan Straits). In the absence of such capital outflows (i.e if item 3 above was zero), M2 growth would be one percentage point higher. It follows from the above figuring, assuming no substantial capital outflows in 1996, that less government bank borrowing, an acceleration in direct lending to the private sector, or a substantial widening in the current account surplus (such as that seen between 1983-1987), are the main channels through which M2 can grow by the requisite amount.

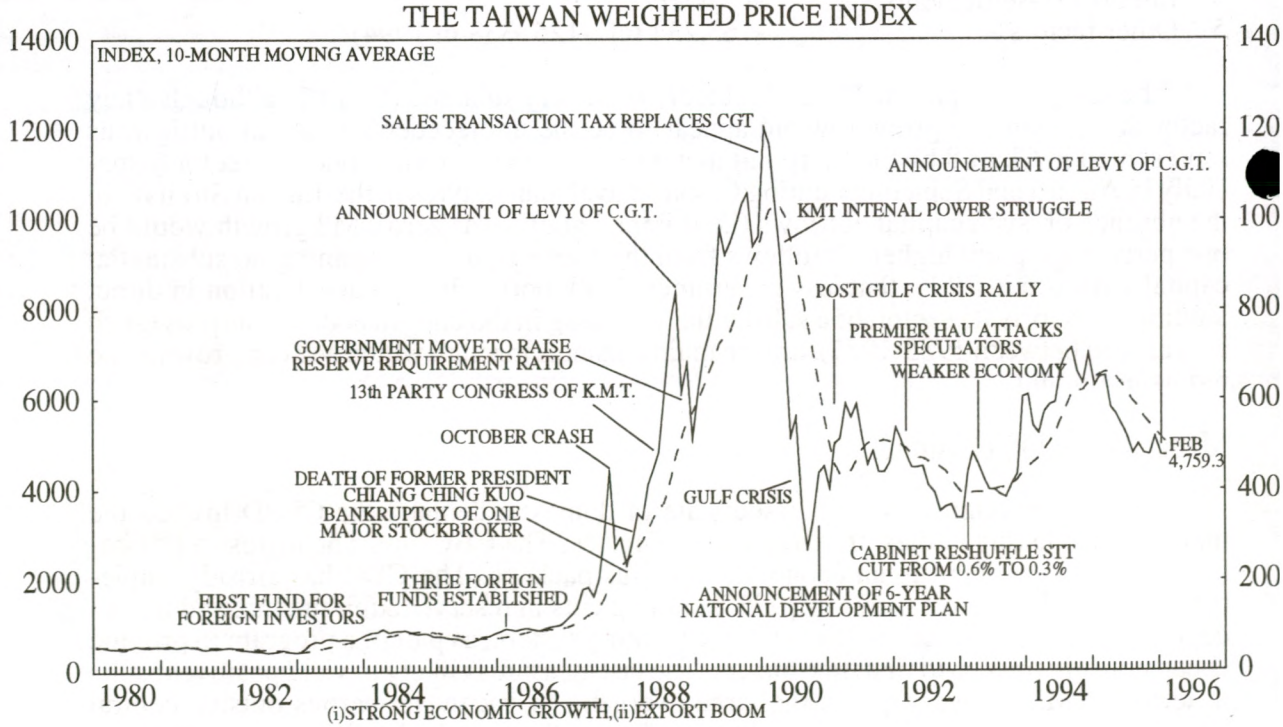
Monetary and Fiscal Stimuli

In acknowledging the depressed state of domestic demand the CEPD invited the main policy making bodies: the Ministry of Finance, The CBC, and The Ministry of Economic Affairs to draw up an economic stimulus package. The CBC has already implemented a number of measures in 1995 including cuts in reserve requirements, and the redepositing of more postal savings with the banking system, as part of a program to provide cheap housing finance to first time buyers. The last measure is likely to yield positive results in terms of M2 recovery, given the large overhang of vacant properties outside central Taipei, and the natural rise in household related expenditures which will occur as properties

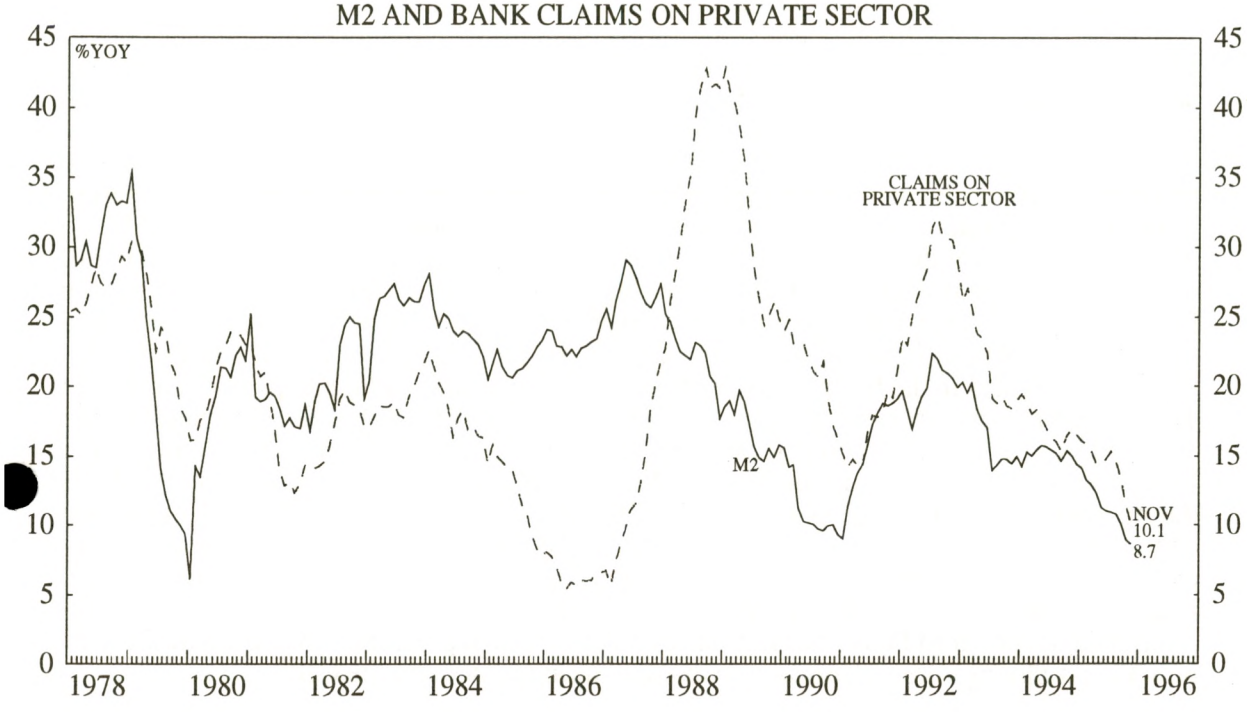
TAIWAN: CHART 5
INFLATION



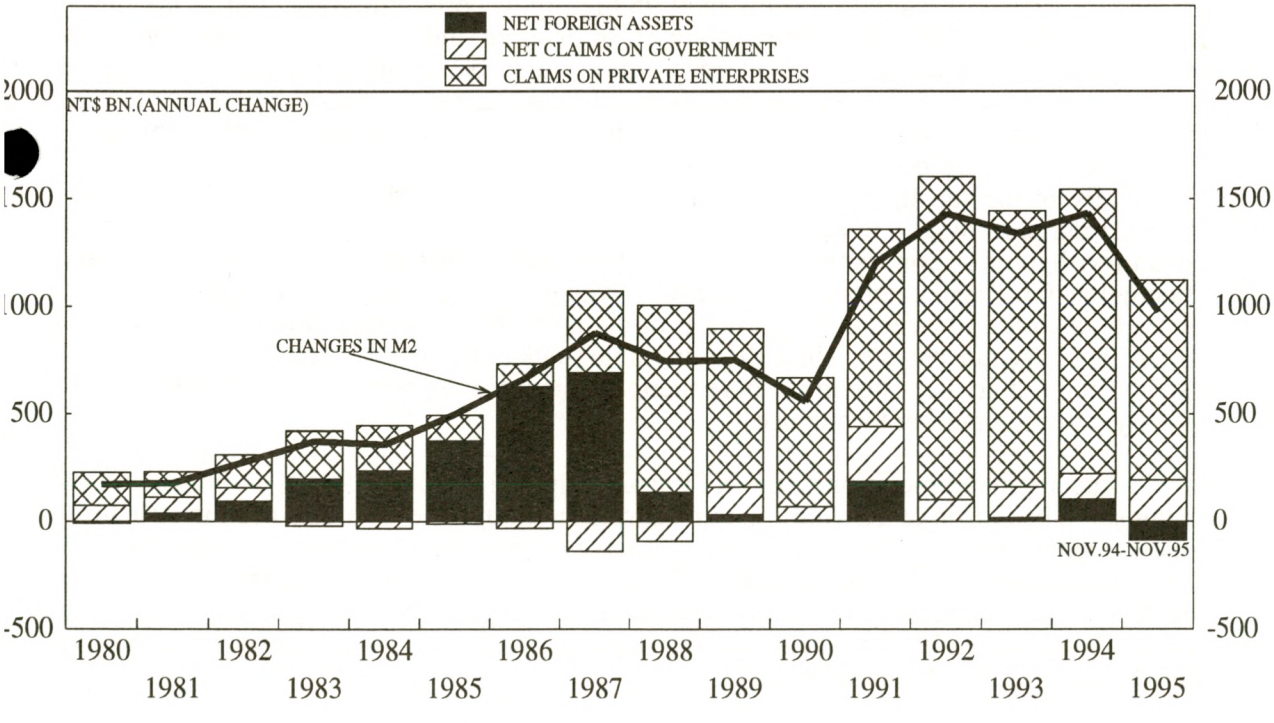
TAIWAN: CHART 6
THE TAIWAN WEIGHTED PRICE INDEX



TAIWAN: CHART 7
M2 AND BANK CLAIMS ON PRIVATE SECTOR



TAIWAN: CHART 8
MAIN FACTORS CONTRIBUTING TO CHANGES IN M2



are purchased. In addition the CBC has operated in money markets to supply liquidity and lower the discount rate. On the fiscal side the Government has announced a 10% increase in total expenditures for FY 1997 and more than 100% growth in the budget deficit. However, deficit finance on this scale is likely to crowd-out private sector investment to a significant degree unless government borrowing is monetised in due course by the CBC.

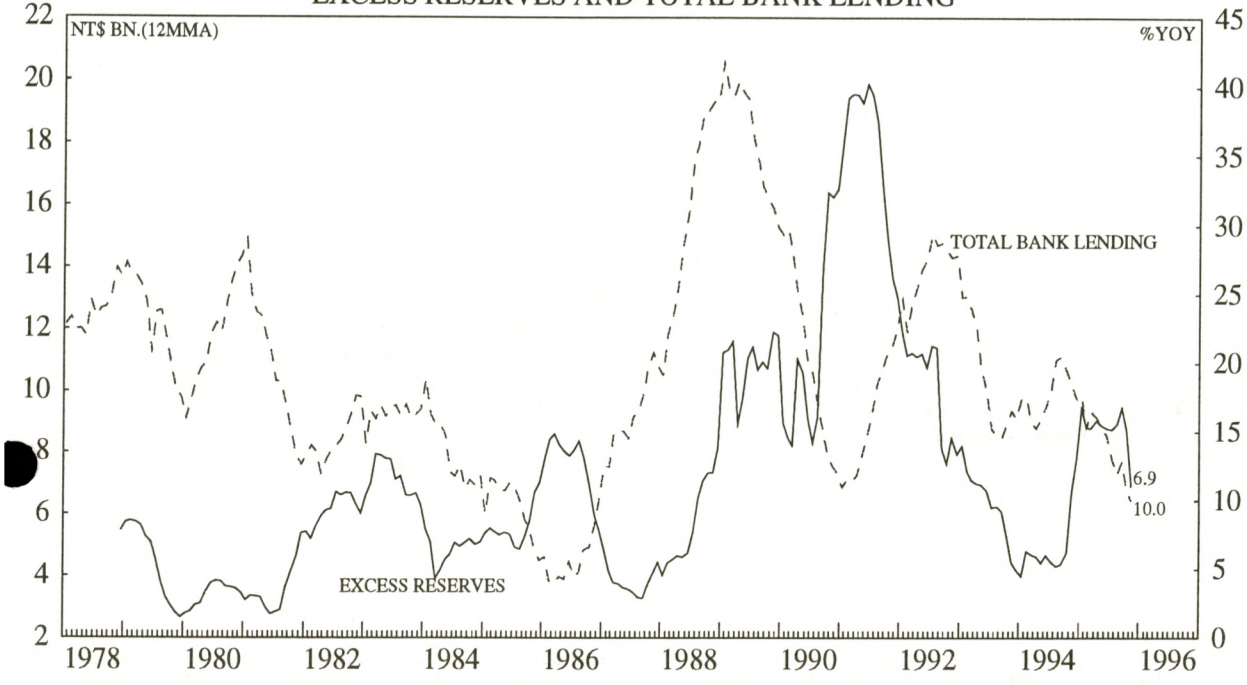
Will direct lending to the private sector recover? One way for this to happen would be for banks to re-channel their excess reserves into loans. However, as shown in Chart 9, a run-down in banks excess reserves over time has been a potentially necessary but by no means sufficient condition for recovery in total lending. Clearly excess reserves tend to fall quickly when lending accelerates, but lending itself appears to driven much more by the business cycle. In that sense the build up of excess reserves in 1994/95 is not necessarily a prelude to growth in lending. More worrying is the recent spate of coincident indicators marking weakness in the business cycle including: decelerating industrial production (Chart 10), and a rise in the ratio 'dishonoured cheques' through 1995. Notwithstanding the subdued state of business activity, perhaps the greatest constraint to growth in lending will be the poor state of the banking system. With significant growth in bad property debts dating back to the "bubble" period (1986-90), and more failures of Credit Unions, the capital base of the banking system is in dire need of re-building. This is one reason why excess reserves may remain at the central bank, or be employed in government funding, rather than be lent out to the private sector. Finally, the flight of deposits out of beleaguered banks and into Postal Savings is acting as a mild depressant to M2 growth (20% of new Postal Savings are redeposited with the banking system by the CBC).

Capital and Trade Related Flows

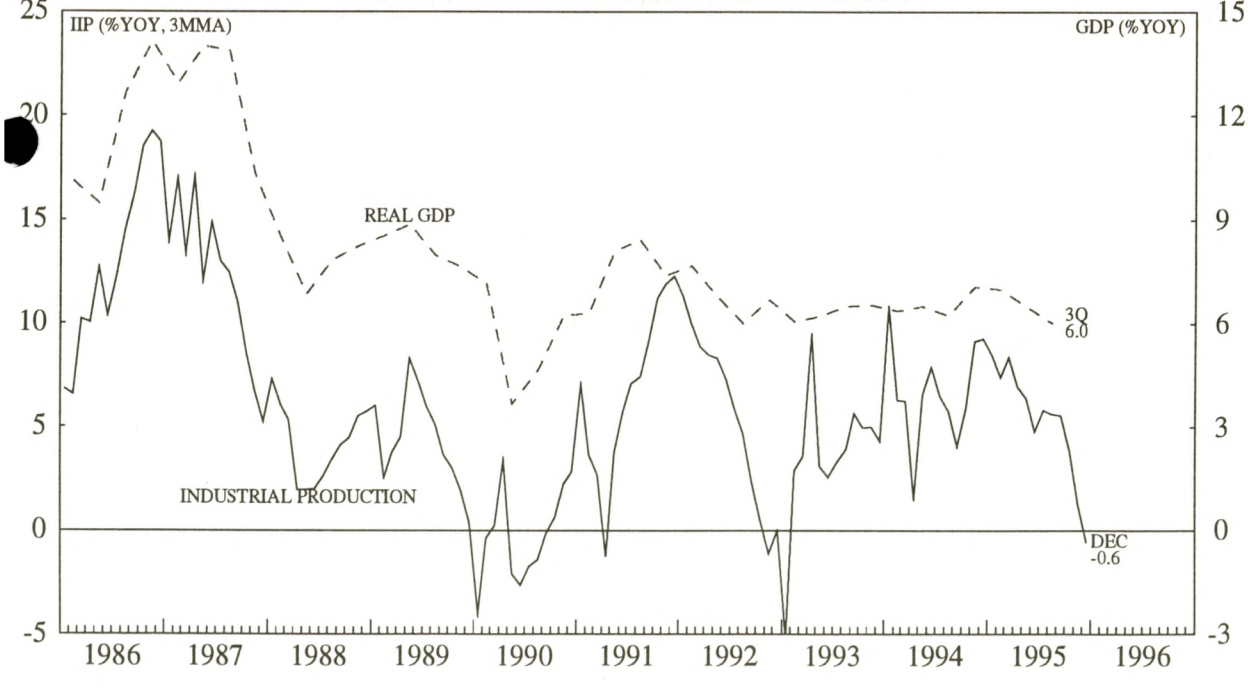
It is not likely that lower interest rates (Chart 11) will act to stimulate lending, as these will probably encourage further capital outlflows in the current environment. The extent and speed of capital outlflow in 1995 highlights certain misconceptions about the relative closure of Taiwan's capital account. In practice, individuals and corporates may remit (inwards and outwards) up to US$5 million and US$ 20 million per year respectively with relative ease. Moreover, most authorised banks are now able to conduct forward foreign exchange transactions relatively freely on behalf of corporate clients without the need for supporting documentation. Capital flows may continue to be volatile in 1996, especially in the run up to Presidential elections in March 1996, and the CBC will be intervening periodically to ensure that currency movements are both controlled and consistent with longer-term trade account objectives. During the current program of monetary easing the CBC will be monitoring Taiwan-Overseas interest rate differentials closely although its ability to target interest rates is obviously limited by what amounts to a broadly fixed exchange rate regime. The CBC's enviable stock of foreign currency reserves, around $90 billion (Chart 12), should be more than sufficient for the purposes of smoothing temporary currency market turbulence.

The slight depreciation of the NT$ against the US dollar in 1995 is to be welcomed against the backdrop of a dwindling trade surplus although the latter has been in structural decline since 1992, as Taiwanese exporters have sought cheaper cost bases overseas. As overseas demand for Taiwanese export slows in 1996, alongside slower growth in OECD economies, the current account may well record a deficit in the coming year. Thus while capital flows may stabilise after Presidential elections, trade related flows remain unsupportive of M2 growth over the medium-term.

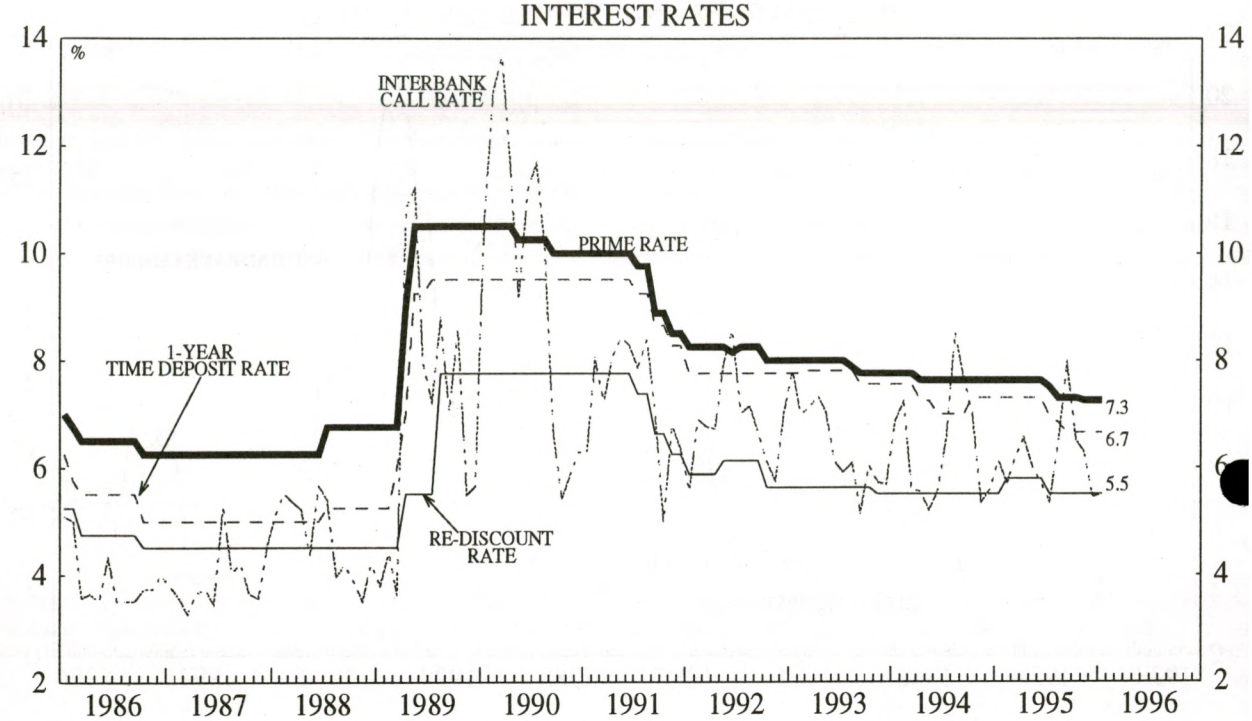
TAIWAN: CHART 9
EXCESS RESERVES AND TOTAL BANK LENDING



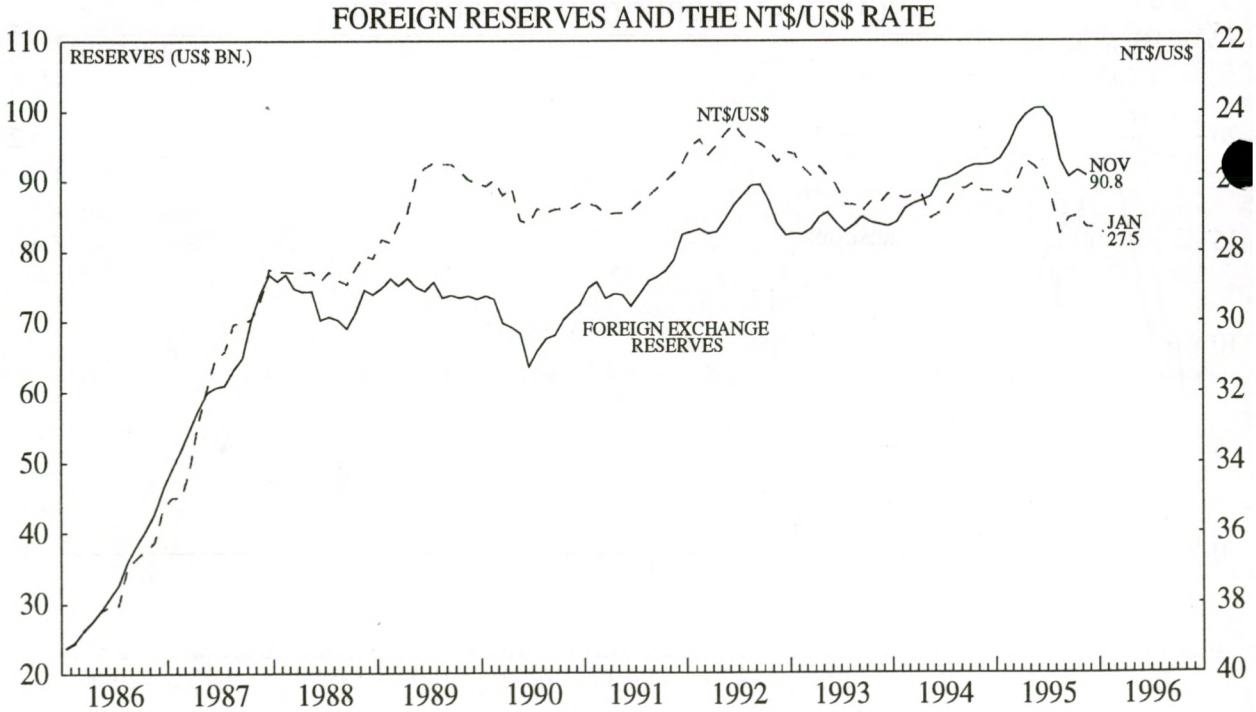
TAIWAN: CHART 10
INDUSTRIAL PRODUCTION AND REAL GDP



TAIWAN: CHART 11
INTEREST RATES



TAIWAN: CHART 12
FOREIGN RESERVES AND THE NT$/US$ RATE



The Equity Market

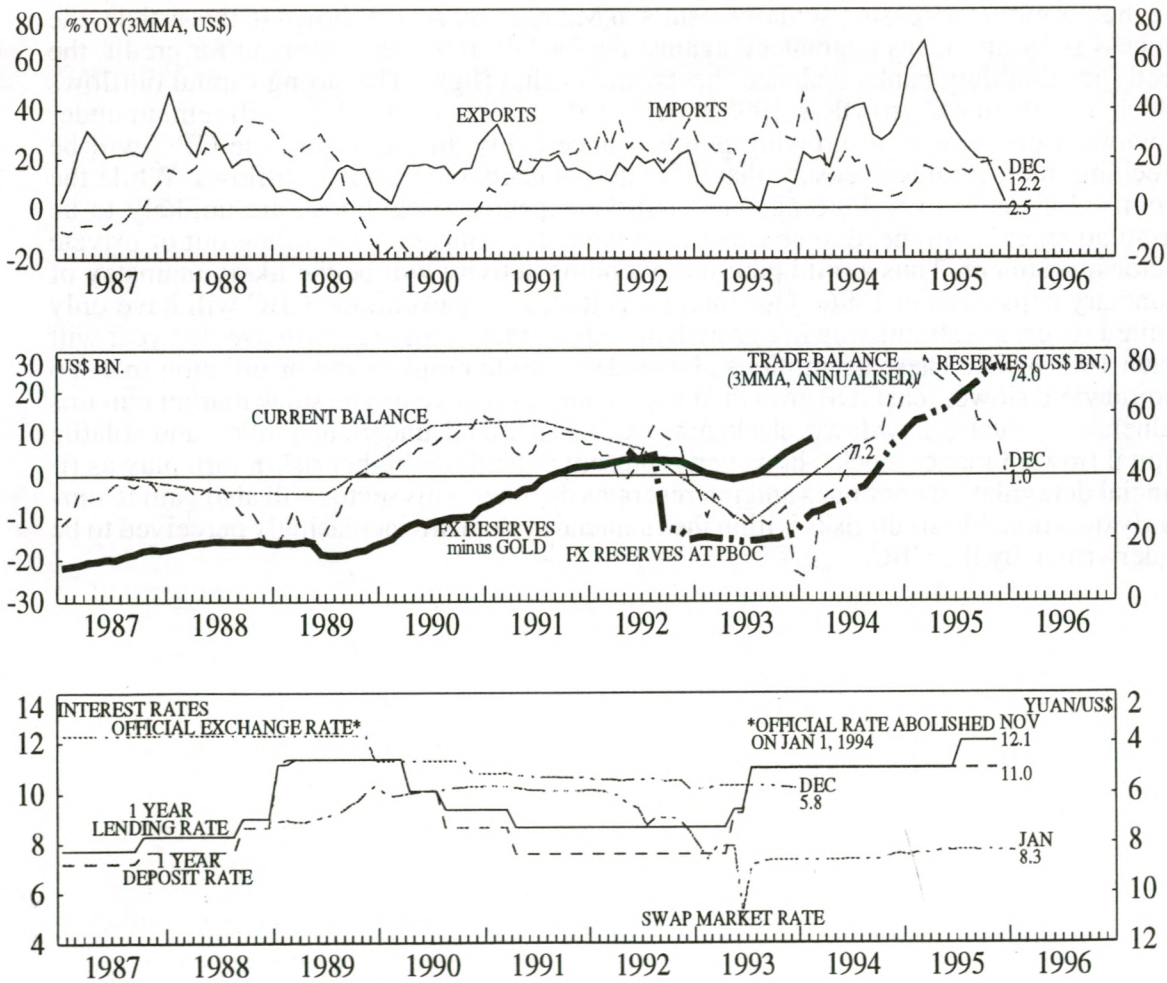
The Taiwan Weighted Index was down 16% over 1995 and fell sharply in the opening days of 1996 after the announcement of sketchy plans for a capital gains tax of 14% on stocks held for less than one year. In a period of weakening economic activity in 1996, and heightened political uncertainty in the run-up to Presidential elections, stockmarket activity will be erratic, although it should be stressed that 35% of index earnings are estimated to derive from exports. Electronics and electricals, mostly export based, represent 18% of the Index but remain vulnerable to potentially slackening overseas demand through 1996. On the other hand, Financials, which account for 34% of the Index, may represent good value in the current interest rate and de-regulatory environment, especially if credit risks within the banking sector become increasingly "underwritten" by the CBC (either through deposit insurance or CBC bail-out packages).

SUMMARY AND CONCLUSIONS: We have shown in this article that growth in Taiwan has suffered in the past two years partly because of a slowdown in monetary growth but also because of weak domestic and external demand. The monetary stimulus currently being provided by the CBC is very much needed if real economic activity is not to weaken considerably from present levels. The main challenge for the CBC however will be ensuring that its monetary easing actually results in M2 growth. As we shown in this article, the process is by no means guaranteed against the backdrop of weak demand for credit, the need for rebuilding banks' balance sheets, and capital flight. The strong capital outflows which depressed M2 growth in 1995 should abate in 1996 but the NT$ will remain under downward pressure amid growing political uncertainty. In this regard the CBC will be checking interest rates to ensure that these do not encourage capital outflows. While the promised increase in welfare payouts, and the expected fiscal boost, are unlikely to be stimulative, care will need to be taken to prevent debt financing crowding out of private sector investment. Thus a mild pick-up in lending activity will be the likely mainstay of monetary expansion in 1996. Our forecast is that, in any event, the CBC will have only limited success in stimulating M2 growth in 1996 so that average growth over the year will reach 10.5% yoy. These asumptions alongside possible rapid easing of inflation in 1996 should yield slower real GDP growth of 6% for the coming year. The stock market remains vulnerable to such a slowdown, slackening external demand, uncertain politics, and volatile capital flows. Finance stocks, however, represent potentially higher risk/return play as financial deregulation continues and interest rates decline. This sector will also gain if currently questionable credit risks within the financial system are increasingly perceived to be underwritten by the CBC.

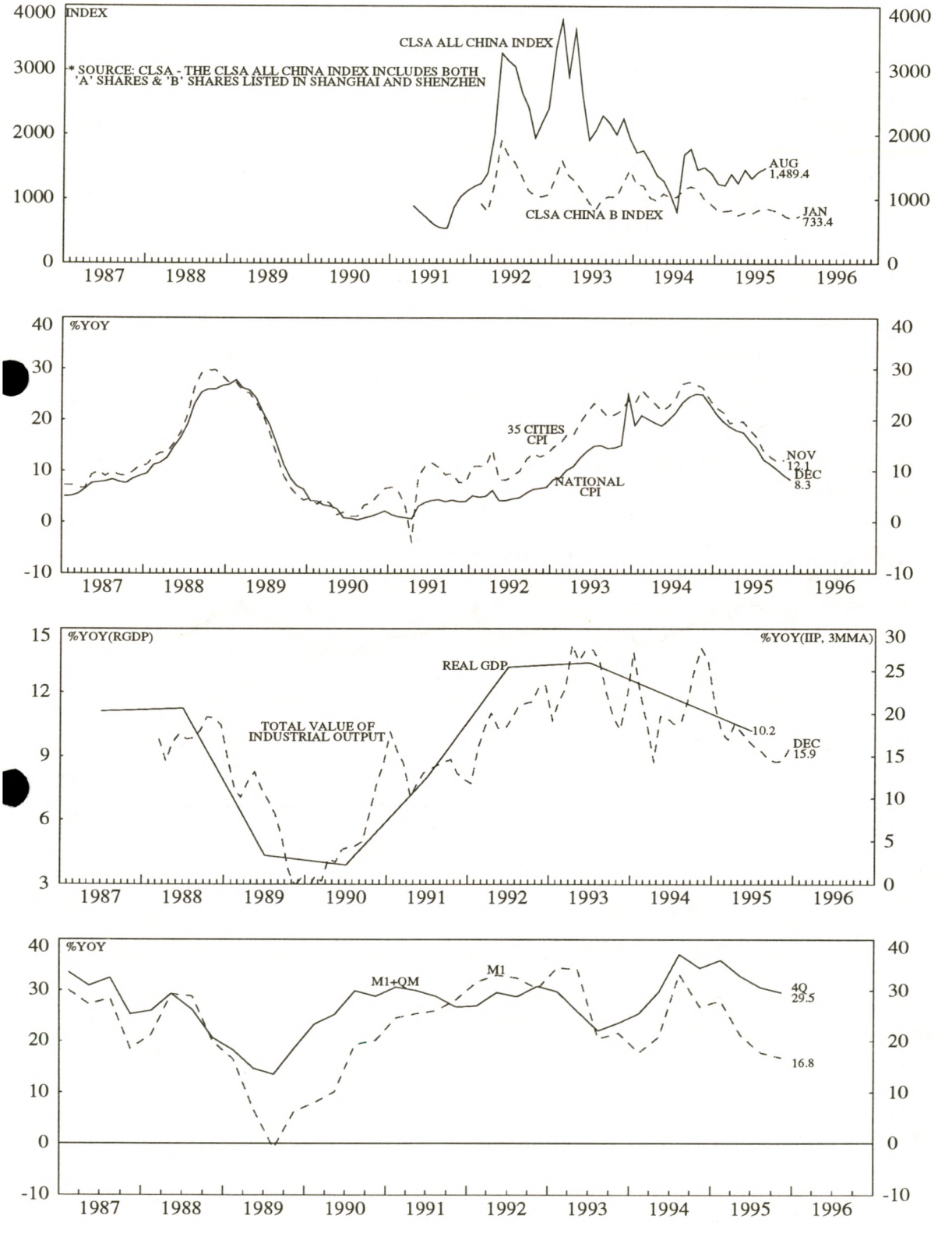
CHINA: THE PROSPECTS FOR CREDIT EASING

Numerous indicators suggest that monetary tightening is finally starting to be effective in reducing output and inflation. The total value of industrial output has fallen from its peak of 28.9% yoy growth in October 1994 to 15.9% yoy in December 1995, while yoy real GDP growth declined to 10.2% in 1995 from 11.8% in 1994. Inflation as measured by national CPI also dipped, to 8.3% yoy, its lowest reading since December 1992. Success in bringing down inflation is probably equally due to price controls as monetary restraint. Nevertheless, selective credit easing is now in prospect in 1996, to be followed by a more generalised credit expansion in 1997. On the external side, the deceleration in export growth over 1995 is signalling a sharp reduction in the current account surplus, and the return to a trade deficit, over 1996. At this juncture, however, a healthy buffer of foreign exchange reserves suggests that any depreciation of the currency, resulting from expected deterioration of the trade accounts, will be both modest and controlled. Further currency market reform and liberalisation is likely over the coming year but the RMB may nevertheless become more unstable if, as we expect, inflationary pressures gather mometum in 1996 H2.

CHINA: MONEY MARKET AND BALANCE OF PAYMENTS



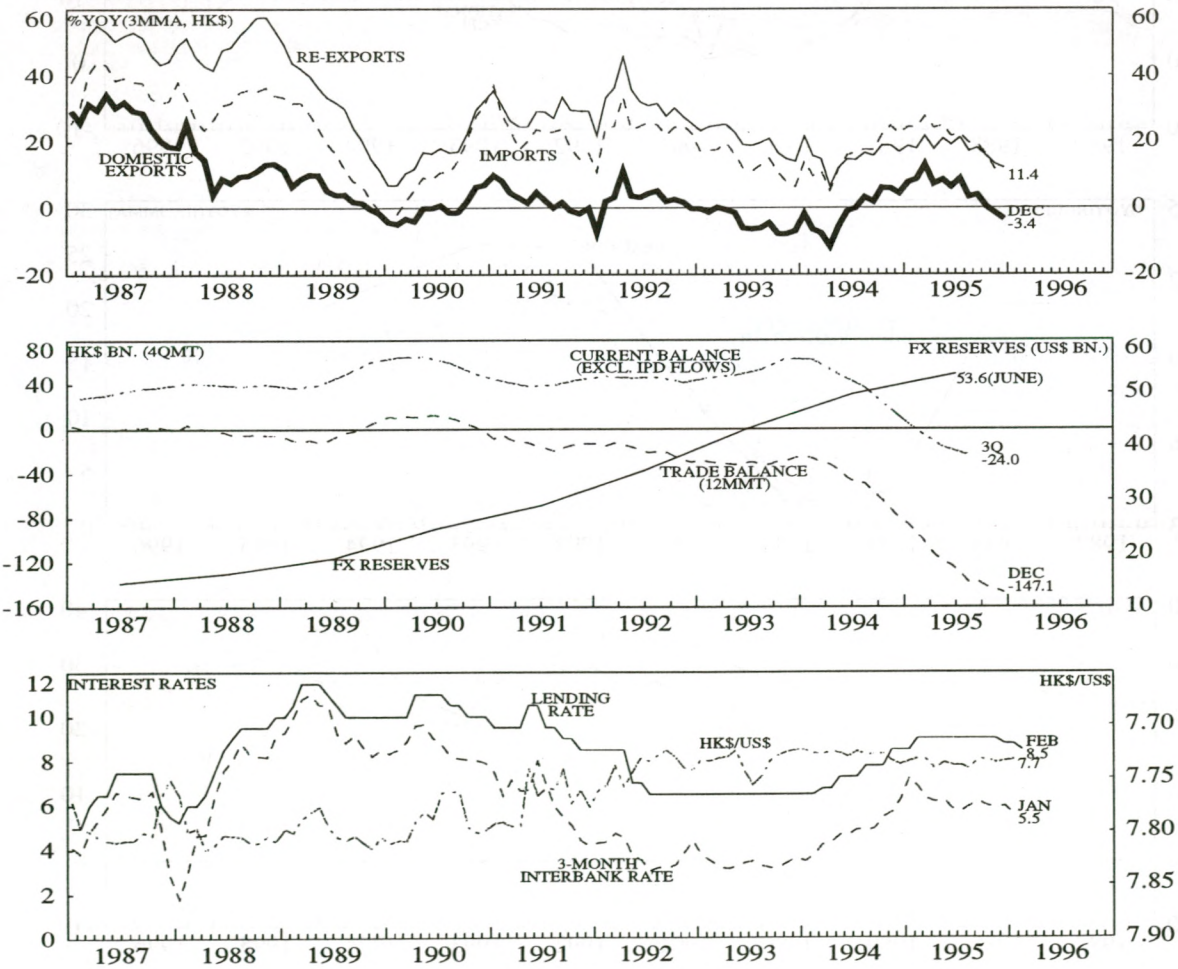
CHINA: MONEY, OUTPUT, GOODS AND ASSET PRICES



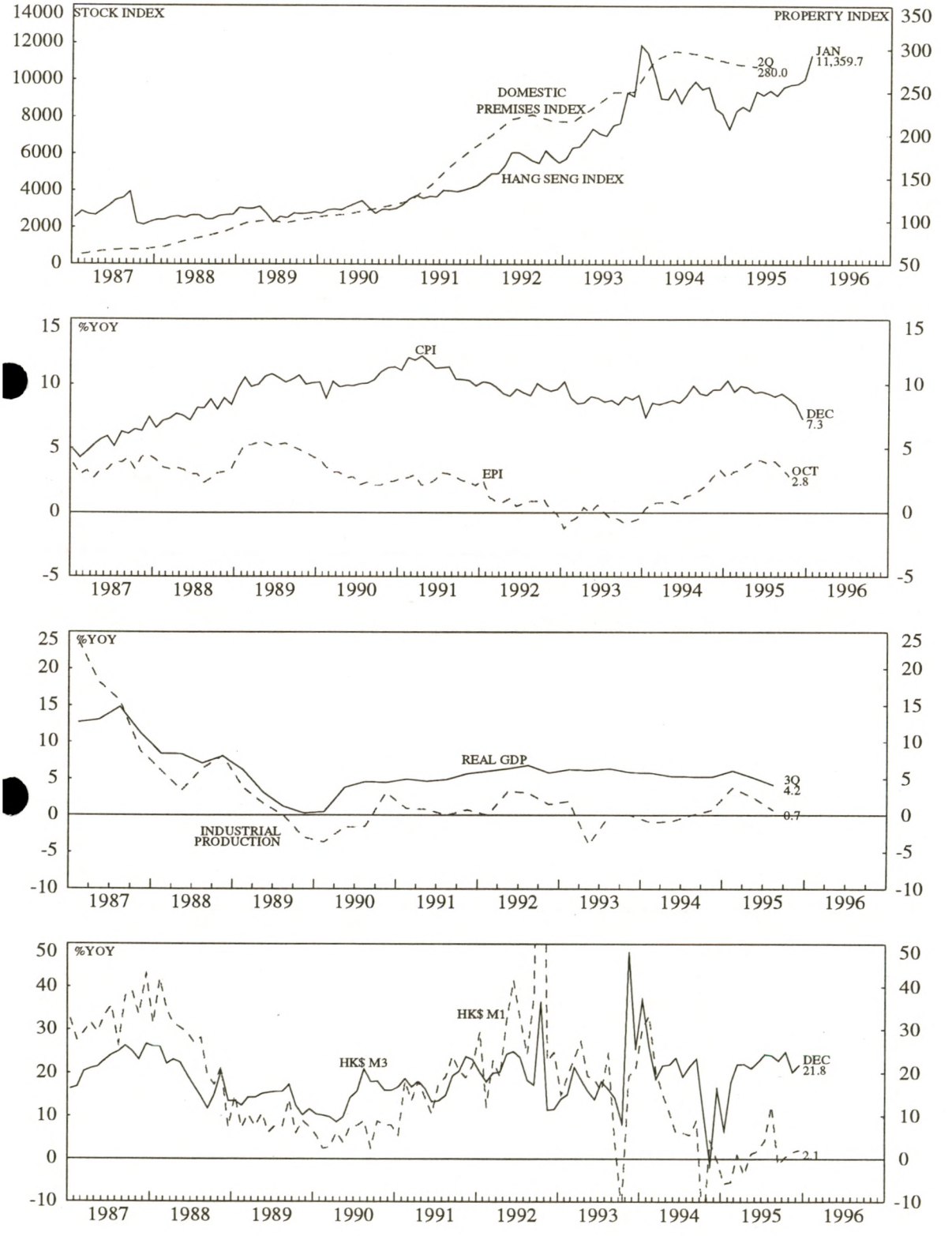
HONG KONG: MARKET AWAITS THE EARNINGS PHASE

The rebound of HK$ M3 over 1995 was from a very low base at the end of 1994. However, at least two fundamental factors also caused liquidity to grow in 1995, boosting Hong Kong's stock market during the year. The first was the growth in liquidity in anticipation of lower interest rates in the US, and subsequently in Hong Kong. The second was liquidity growth amid growing perceptions of slowing economies in both Hong Kong and China. Several indicators suggest that economic activity in Hong Kong was subdued in the past year, and likely to remain so through 1996 H1 at least. First, the inventory build which supported GDP expansion in early 1995 is now unwinding, but will continue to depress GDP growth. Second, lending rates in Hong Kong have now started to inch downwards alongside US interest rates, but bank loan growth remains subdued. Third, average inflation maintained its downward trend in the second half of 1995 (turning HK$ interest rates mildly positive). Finally, the trend away from domestic exports to "trans-shipment", and strong import growth, continues to contribute to a steep deterioration in the trade balance. Looking ahead, liquidity conditions should remain supportive of the equity market in 1996 H1, while private consumption and the property market remain temporarily subdued. Moreover, economic recovery in China and Hong Kong in 1997 and beyond leaves room for upward revisions to earnings expectations.

HONG KONG: MONEY MARKET AND BALANCE OF PAYMENTS



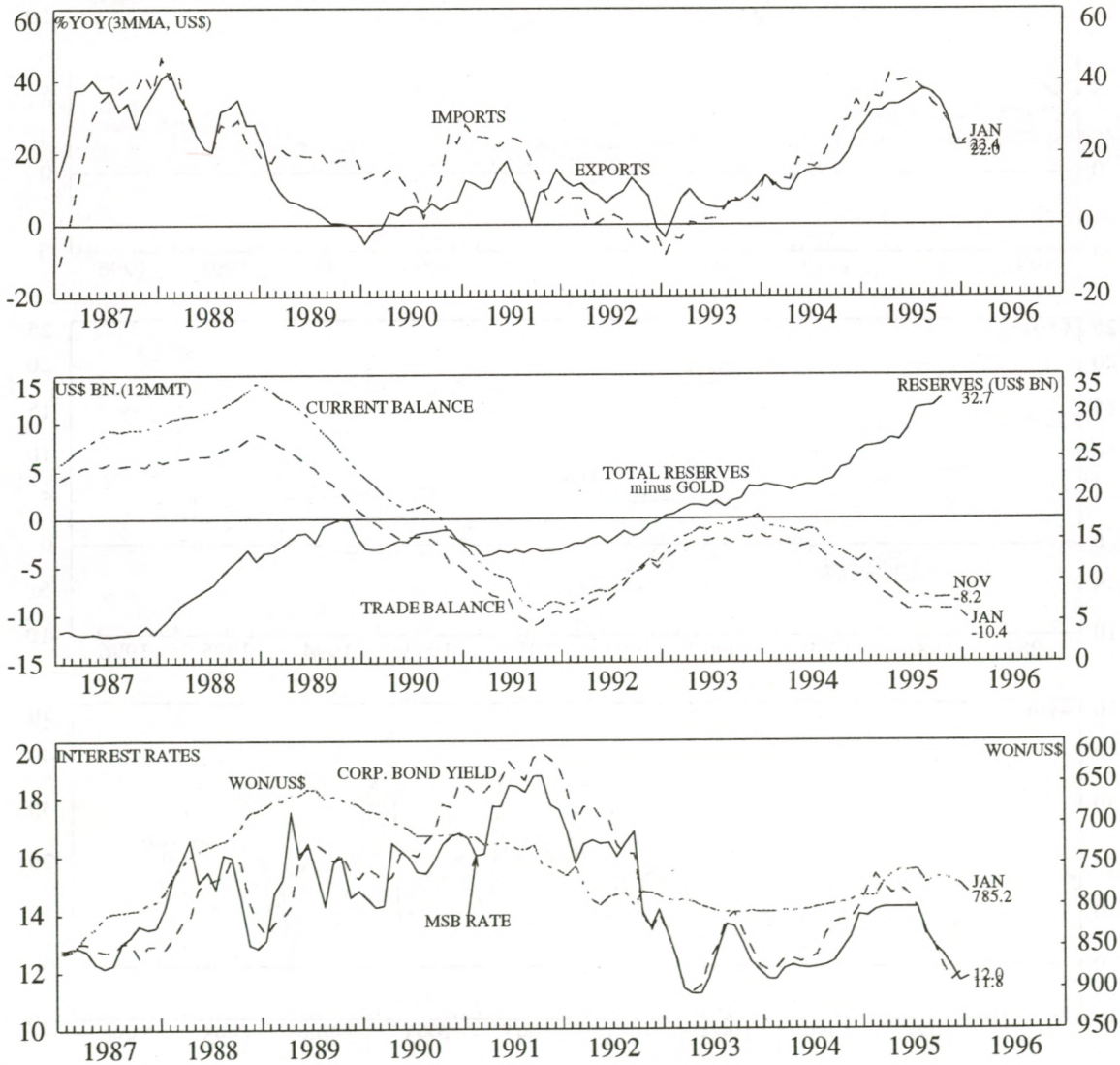
HONG KONG: MONEY, OUTPUT, GOODS AND ASSET PRICES



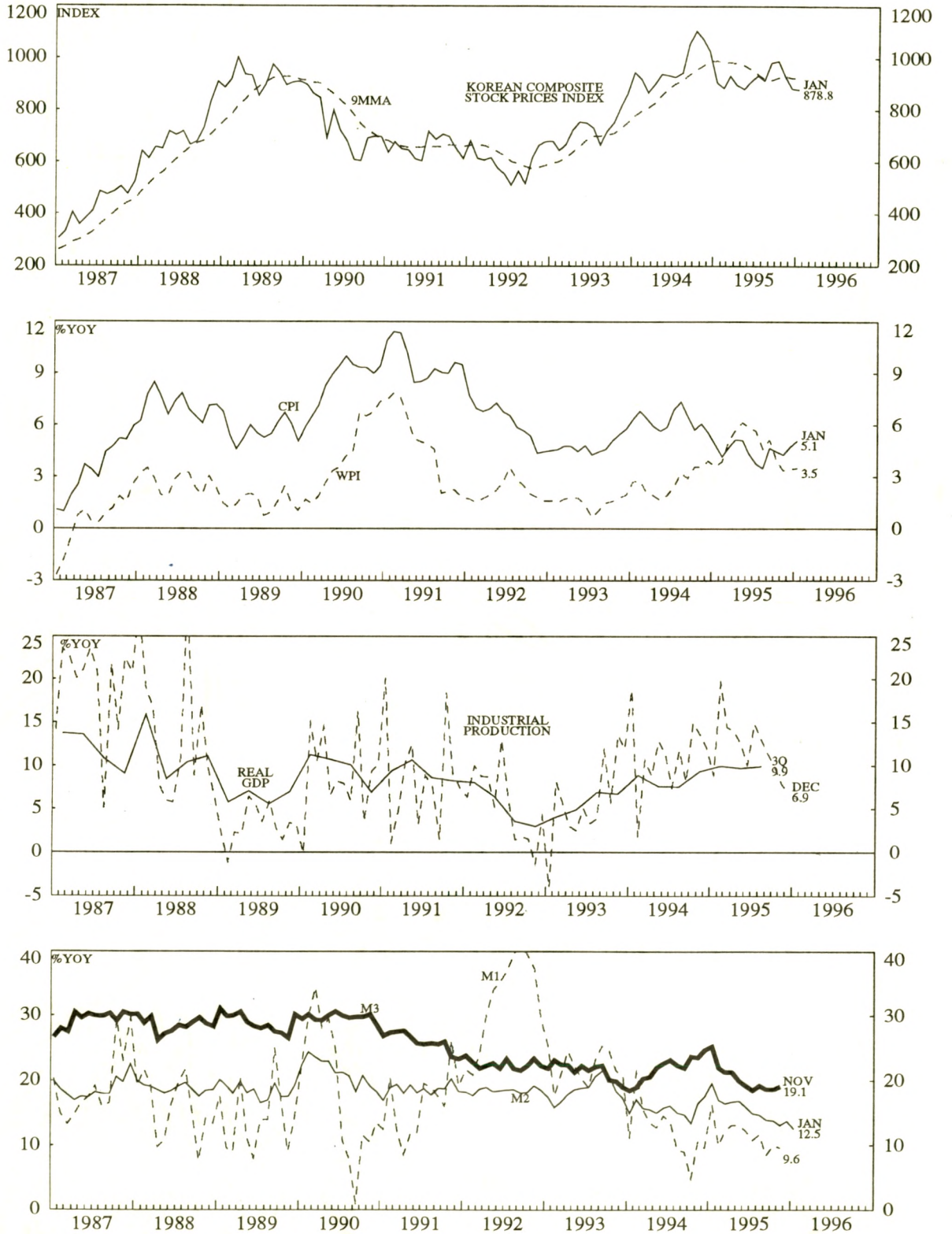
KOREA: FROM OVERHEATING TO SOFT LANDING

Overheating in the first half 1995, particularly evident in investment, industrial production and imports, has eased somewhat in the second half of the year. This has been partly in response to a less favourable external environment (weaker export demand and less relative exchange rate competitiveness vis-a-vis Japan) and partly due to domestic political uncertainties and the delayed effect of the high interest rate policy in the first half of 1995. However, the easing of interest rates since the middle of 1995 has stabilised the growth rate of M3 at a pace consistent with a "soft landing", i.e. a modest deceleration of real GDP growth to 7-7.5% in 1996 with a moderation of inflationary pressures and trade account imablances. The low corporate bond yield and resilient growth of broad money (neither of which is likely to be tightened unnecessarily ahead of the parliamentary election in April 1995 and the presidential elections in 1997) should also provide some support for an equity market which did not benefit much from the earlier overheating.

KOREA: MONEY MARKET AND BALANCE OF PAYMENTS



KOREA: MONEY, OUTPUT, GOODS AND ASSET PRICES



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ASIAN MONETARY MONITOR

March-April 1996 **Vol. 20 No. 2**

CHINA
NEAR-TERM EASING, LONG-TERM QUESTIONS

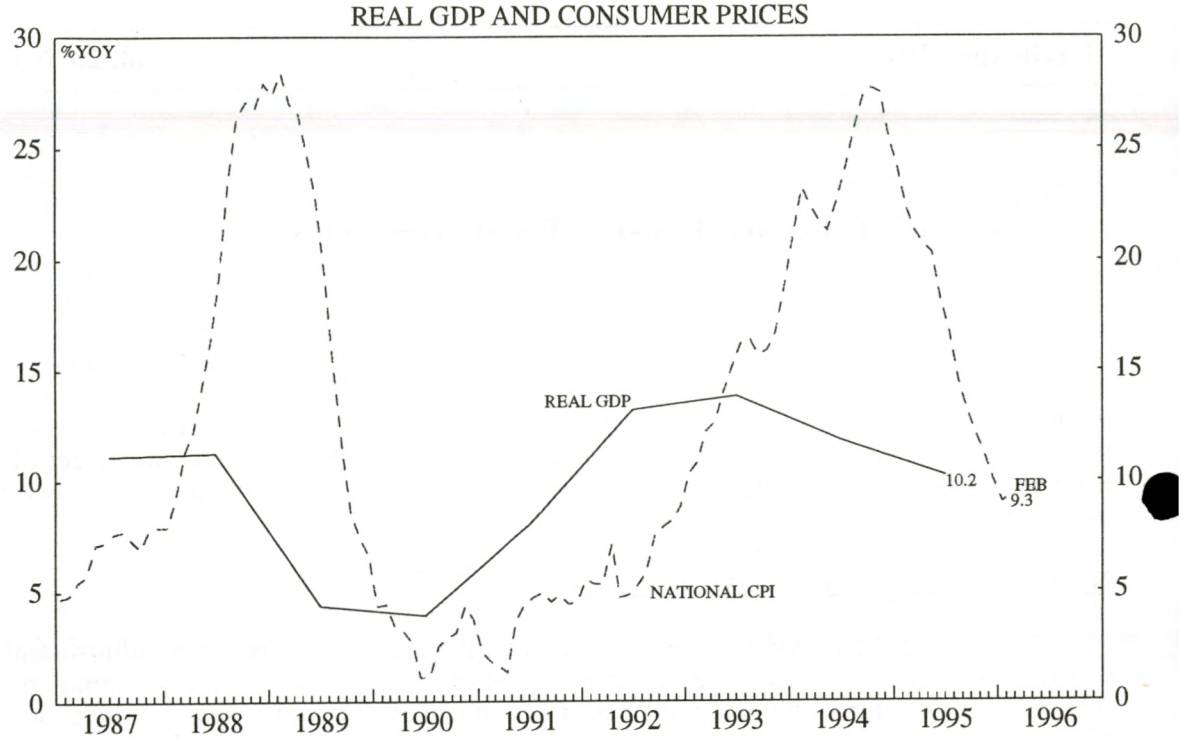
Recent official economic data show that China's government has met its objectives of slowing (but not stopping) an overheating economy. Real GDP growth slowed to 10.2% yoy in 1995 (from 11.8% in 1994) while RPI inflation decelerated to below 8% in the first 2 months of 1996 (from over 20% a year earlier). This overall apparent policy success has led to growing demand for an easier stance of policy, which we expect will be endorsed at the summer 1996 economic conference. To understand the likely nature and effect of the forthcoming easing of policy, let us first take a closer look at the nature of the recent slowdown in growth and inflation.

Nature of the Recent Slowdown in Inflation

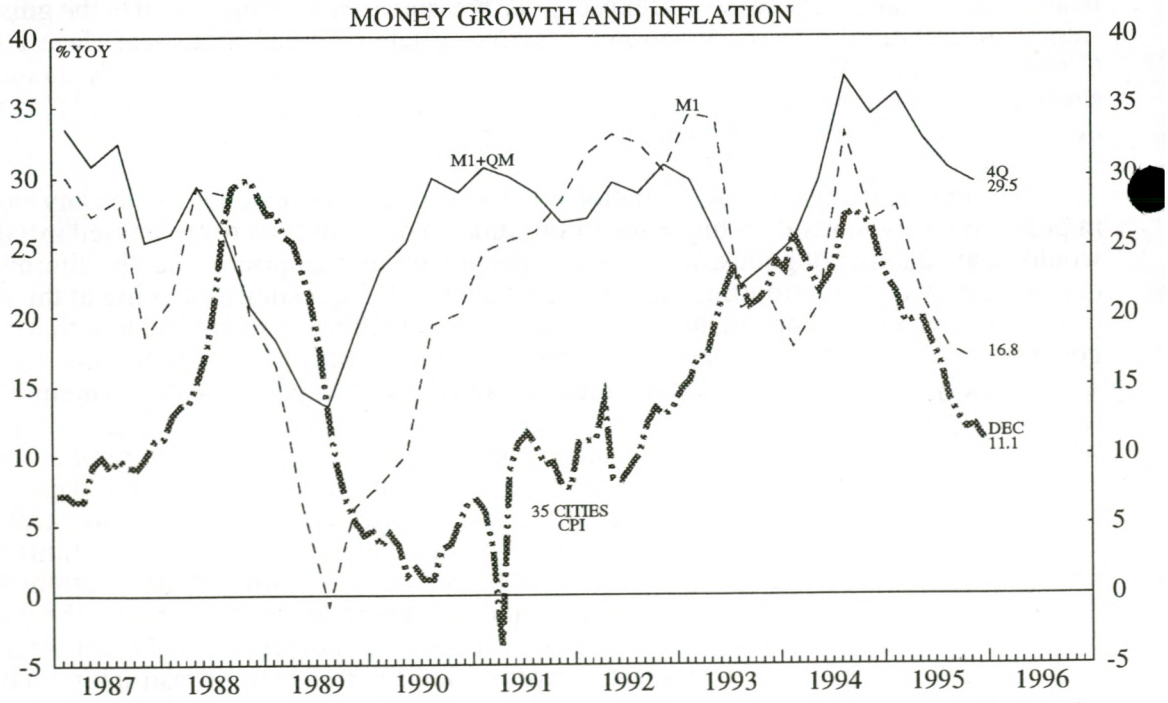
The recent slowdown has been achieved with a mix of old-fashioned administrative controls as well as increased use of more market-oriented tools of demand management. Administrative controls have included controls on prices of certain 'key' products and on the issuance of licences for imports, capital construction, etc. Economic development and efficiency depends in large part on 'getting prices right' in order to allocate resources to their most optimal uses. When price controls are binding and keeping prices significantly below equilibrium levels, we would expect price pressure to rear its ugly head in the guise of 'repressed inflation'. As discussed in a previous article ("China: Statistical Haze Hides Growth Path" in AMM May-June 1995) repressed inflation can take many forms, including shortages, dual (i.e. black) markets with higher prices, declining quality of goods (as producers skimp on inputs while trying to meet output targets), etc.

The extent of any repressed inflation is key to assessing the extent to which any easing in policy is likely to result in higher overt inflation. The main tests for repressed inflation would be availability of goods, and price compared with 'border prices' (i.e. the alternative or opportunity cost of importing and exporting the good in question). Looking at the windows and shelves of shops in any of the main cities in China, it seems evident that most goods are now available, and generally at prices not too far out of line with 'border prices'. This is hardly surprising given that the authorities have over the past year shown themselves increasingly willing to alleviate domestic shortages with further imports. The main areas where domestic prices are still significantly below 'border prices' are agricultural procurement prices and fossil fuel prices. However, the discrepancy between agricultural procurement prices (which paid for quota output) and market prices (paid for output in excess of quota) can be viewed as rent payable in kind by farmers to their landlord the state. Similarly, the cheap (in effect subsidised) prices of fossil fuels combined with high (protectionist induced) prices of cars can be viewed as a social development policy to promote the use of public transport and help reduce the transport cost element of other prices. Of course more transparent land rents or profit taxes, and improvements in transport infrastructure may be more economically efficient ways to pursue the same policy objectives. However, overall, from the micro-economic perspective of looking at individual goods, signs of repressed

CHINA: CHART 1
REAL GDP AND CONSUMER PRICES



CHINA: CHART 2
MONEY GROWTH AND INFLATION



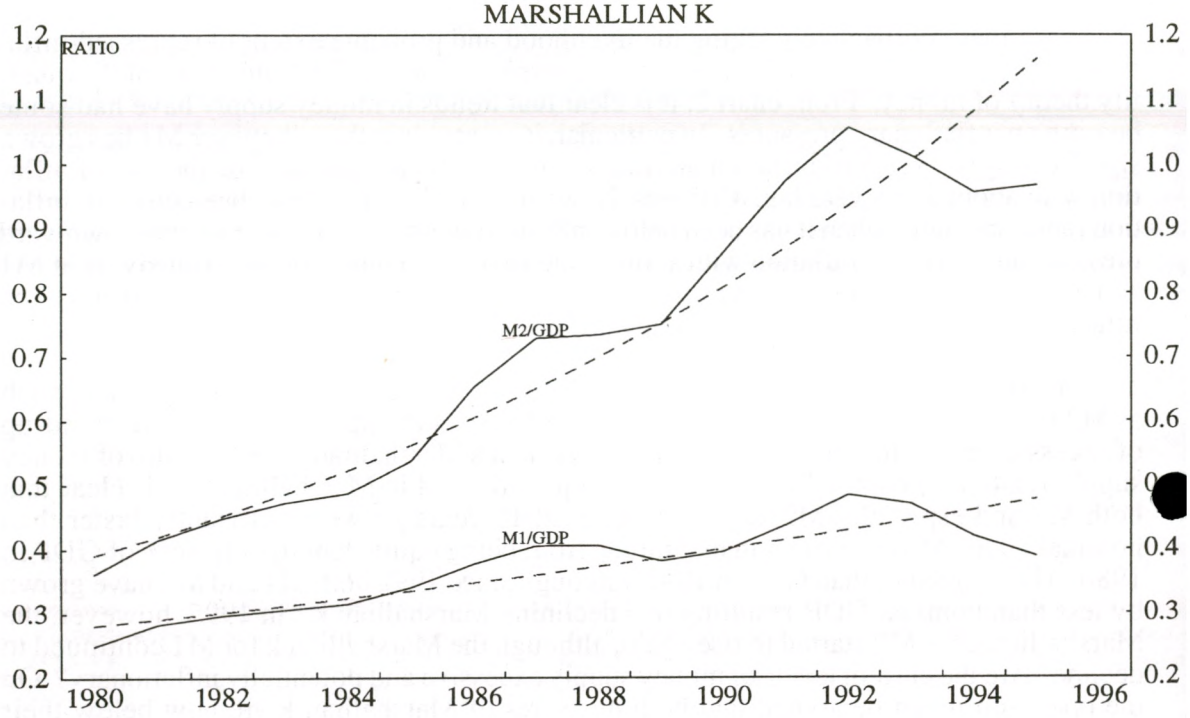
inflation appear to be significantly less in evidence than was the case 1-2 years ago.

Another approach to gauging the likelihood and probable extent of repressed inflationary pressures is from a macro-economic perspective within the framework of the quantity theory of money. From chart 2, it is clear that trends in money supply have had some bearing on inflationary pressures. In particular, it seems clear that whenever M1 has grown significantly in excess of inflation this has resulted in upward pressure on the rate of inflation with about a one year lag. Conversely, whenever M1 growth has been close to inflation (and especially when it has been below inflation) this has tended to exercise downward pressure on the rate of inflation with about a one year lag. Thus, looking exclusively at M1 and 35 cities CPI (and bearing in mind China's rapid real GDP growth), there appears to be little support for the idea of incipient upward pressure on inflation.

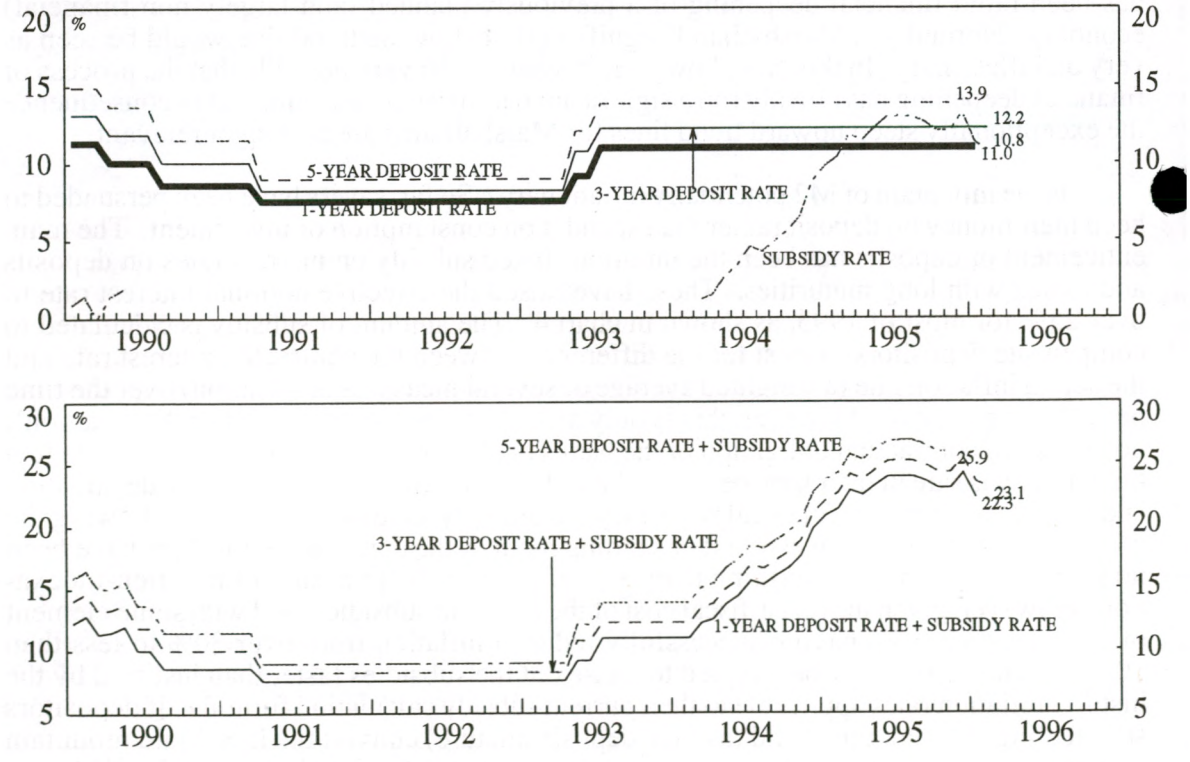
However, looking at the recent growth rates of a broader monetary aggregate, such as M2 (i.e. M1 plus Quasi-Money time deposits), there still appears to been some build-up of excess money in the system. Chart 3 shows China's Marshallian k, i.e. the ratio of money supply relative to nominal GDP. From the upward trend in Marshallian k, it is clear that both M1 and especially M2 have over the past 15 years grown significantly faster than nominal GDP. M2 has grown in magnitude from being equivalent to only 36% of GDP in 1980 to being greater than GDP in 1992; although since 1992 both M1 and M2 have grown by less than nominal GDP, resulting in a declining Marshallian k. In 1995, however, the Marshallian k for M2 started to rise again, although the Marshallian k for M1 continued to decline. Are the current levels of money supply excessive and potentially inflationary? On the one hand it can be argued that both measures of Marshallian k are now below their respective trend lines, and are also at low levels relative to similar measures for several other developing countries. On the other hand, the trend lines are extremely steep by international standards, and are calculated over a very short time span during which there has been rapid financial deepening of a previously planned (and largely non-financial) economy. Normally, a Marshallian k significantly below the trend line would be seen as very disinflationary. In this case, however, it would seem very possible that the process of financial deepening has already run a significant part of its course, and that in consequence the exceptionally steep upward trend lines for Marshallian k are no longer relevant.

Is the mountain of M2 potentially inflationary? So far, savers have been persuaded to keep their money on deposit rather than spend it on consumption or investment. The main enticement of deposits has been the inflation-linked subsidy on interest rates on deposits and bonds with long maturities. These have raised the effective nominal interest rate to over 25% for most of 1995, as shown in chart 4. The amount of subsidy is calculated to compensate depositors ex post for the difference between the contracted interest rate and the actual inflation rate (a weighted average of several measures of inflation) over the time period of the deposit. However, this is only an implicit promise of inflation 'indexation', not an actual contractual obligation of the banks or the government. As long as people feel their money is safe in their time deposits - i.e. safe from inflation, from possible devaluation and from other forms of financial risk - they are unlikely suddenly to start withdrawing the money and spending it, investing it or sending it out of the country. So far there have been no signs of the authorities wishing to renege on their implicit promise of inflation-indexation. However, given the quasi-fiscal cost of the inflation subsidies, and with some element of complacancy from having successfully reduced inflation from over 30% to less than 10%, the authorities may be tempted to phase out the subsidies faster than justified by the historic inflation rates applicable to their current subsidy calculation formula. If depositors start feeling cheated, this could (as time deposits mature) convert the less liquid mountain of quasi-money into a more liquid (and potentially more inflationary) mountain of M1.

CHINA: CHART 3
MARSHALLIAN K



CHINA: CHART 4
INTEREST RATES



Although deposit rates have played a key role in demand management in terms of providing a reward for saving and a high opportunity cost for consumption, lending rates have not been adjusted markedly and have not played any significant role in constraining corporate cashflow. Instead, the authorities have relied on traditional methods of credit control to restrain facilities investment. The constraint on credit growth, combined with the dramatic growth in time deposits, raises the question of where the money has gone. The central bank has successfully restrained growth in its own balance-sheet, strictly limiting the rediscounting of lending by the state-owned commercial banks, and not accepting excess reserve deposits from the commercial banks. It has also been restrained in its foreign exchange intervention, while still providing guidance for the exchange rate and allowing the commercial banks to hold greater amounts of foreign currency. One can therefore expect that commercial banks will have held some amount of their deposits in foreign assets — in effect conducting the sterilised foreign exchange intervention which the central bank has refrained from doing. However, given the growth in time deposits, the state-owned commercial banks would still have more funding than they were allowed to extend in credit or than they would have placed in foreign currency deposits, and it would not be surprising if some had found its way into the economy through various types of 'quasi-credit' and other assets (e.g. investments in non-bank subsidiaries or in bonds, accumulation of arrears on non-performing loans, etc). Another possible counterpart for the rise in deposits would be a fall in the net worth of the state-owned commercial banks, which may well be the end result of a resolution of the problems of non-performing assets.

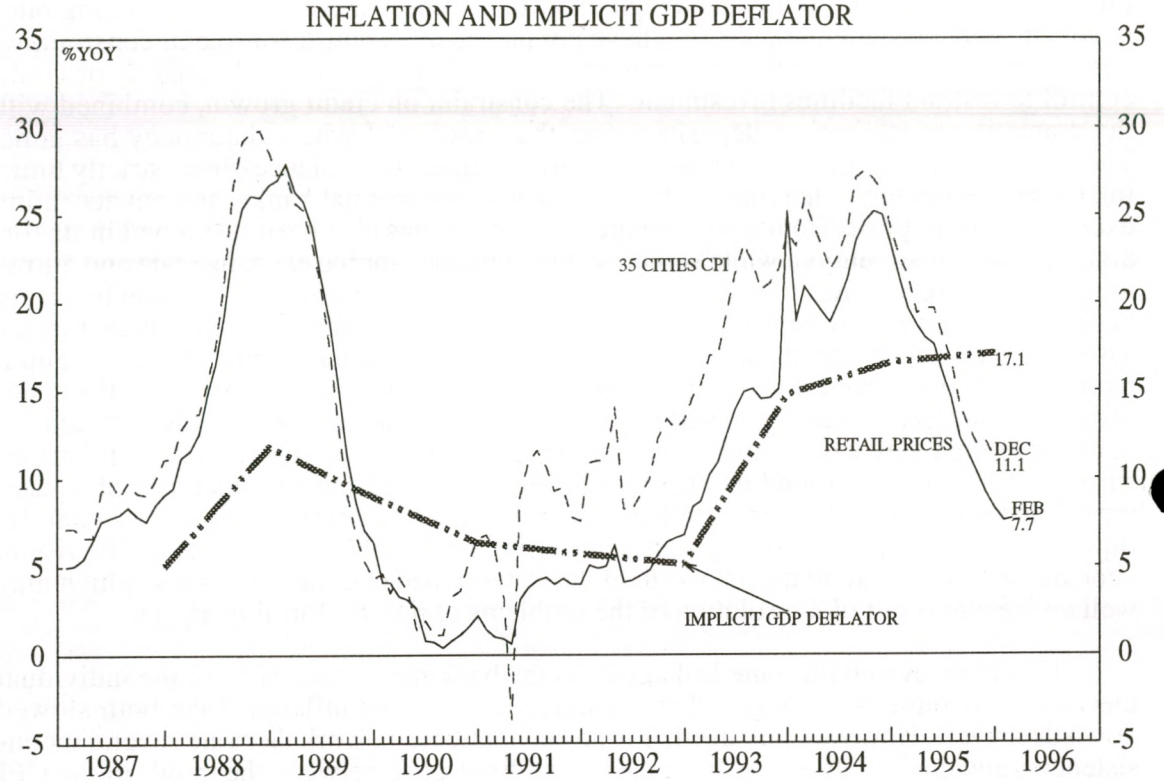
However, even with some leakage from the banking system, most of the individual pieces of economic data suggest that economic activity and inflation have both slowed down decisively. However, put together in an economic framework there are several inconsistencies and contradictions such as: the recent divergence between the trends of the CPI and the implicit GDP deflator (as shown in chart 5), the increase in output of state owned enterprises without further labour input, the gap between tight credit and soaring time deposits (discussed in the paragraph above), etc. So far these and other data inconsistencies (several of which have been discussed in previous AMM articles) have not scared foreign investors but only caused minor concern among some analysts and economists.

Near Term Easing, Long Term Questions

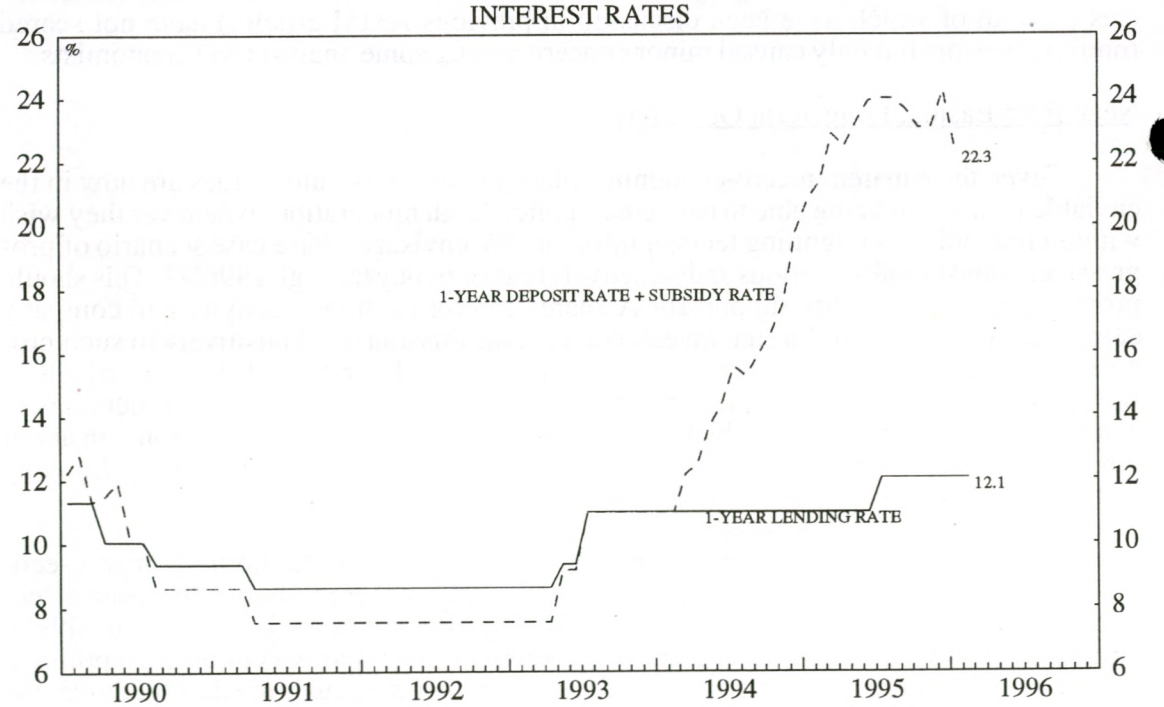
Given the apparent macro-economic policy successes, the authorities are now in the enviable position of being able to ease credit policy (with moderation) whenever they wish without immediately reigniting fears of inflation. We envisage a base case scenario of progressively (and initially cautious and selectively) easier policy through 1996/97. This should provide domestic liquidity support for A-shares and for economic activity and company earnings. Assuming that foreign investors recognise this and react positively to such progressive and cautious easing, it could also provide for rapid re-rating of shares available to foreign investors. In the first quarter of 1996, foreign portfolio investor sentiment has of course been somewhat clouded (by China's missile tests near Taiwan and by concern about possible increases in US rates etc.), providing potentially a good buying opportunity. Looking further out, economic policy credibility will depend on a number of factors:

How effective will the forthcoming credit easing be? So far both the macro-economic data and our company research suggests that the tight credit policy has been effective in tightening the funding conditions for the majority of companies who are unable to circumvent the policy through funding from foreign business partners or through political connections to secure 'selective easing' of credit for their particular needs. Of course, the flow of the credit can only be 'selective' and 'controlled' in the first round, as the state-

CHINA: CHART 5
INFLATION AND IMPLICIT GDP DEFLATOR



CHINA: CHART 6
INTEREST RATES



owned enterprises which receive the credit initially will use it to pay workers and suppliers, who in turn can spend the funds or recycle it in either the formal or in the informal financial sector. In the formal banking sector, the selection of specific exemptions to the tight credit policy has been done on the basis of political sensitivity and not on the basis of economic efficiency. As shown in chart 6, lending rates have hardly been adjusted, and are significantly below (inflation-adjusted) deposit rates. State-owned commercial banks are still effectively operating as agents of fiscal, industrial and employment policy, not as profit-maximising, efficiency enhancing financial intermediaries. As most of their credit is to the state sector, it could be argued to have zero risk-weighting and therefore not influence capital ratios. With such a banking system one cannot think of mechanical and stable money and credit multipliers. The main constraints on credit expansion are the overall credit plan and the degree of central enforcement of this plan vs. the scope for local circumvention of the plan. The availability of funding from deposit savings and from central bank credit, as well as asset quality, look set to remain less binding constraints until such time as proper bank accounting and audit systems are in place (probably not for several more years). The productivity of any new lending and investment will depend on whether it is allocated according to market signals or according to political patronage. Of particular importance in this area is the proposed development of a nationwide interbank market for funds, which in due course could play a significant role in determining market clearing interest rates and allocating available credit more efficiently.

Another crucial question for market efficiency is the urgent creation of a proper legal framework for a market economy (e.g. property rights, contract law, etc.). Can the present framework be improved to facilitate more market dynamism and efficiency gains? How swiftly will the authorities create effective legal and financial accounting divisions between the government, the state owned enterprises, the state owned banks, and the individuals employed by each. How healthy will the final accounts of each appear? Will there be a rationalisation of perverse price structures such as the deposit rate exceeding the lending rate (discussed above) and some procurement prices exceeding final retail prices? Will there be a solution to the problem of intra-company debts and the resulting damaging culture of non-payment? Will the cumulative deficit of the consolidated public sector be funded by overt taxes, bond issuance, or simply by monetization and inflation tax? One risk to our 'progressive easing, continued rapid growth' scenario is that continued apparent economic success may well breed complacency on these important longer-term structural issues.

What will happen to the currency? It is much easier to talk of current account convertibility when (as has been the case recently) the country is running an overall balance of payments surplus. However, although China's economy is quite open (in terms of trade as a proportion of GDP) it still has many administrative means to control foreign currency transactions (i.e. you can buy foreign currency freely as long as your import permits and other papers are in order). Increased currency convertibility and easing of these controls could make it more difficult to maintain an exchange rate compatible with stable growth and low inflation.

SUMMARY AND CONCLUSIONS: China has succeeded in cooling down the pace of economic activity and the rate of inflation. The previously tight credit policy looks set to be eased over the next 12-18 months. If handled carefully, such an easing need not necessarily reignite inflationary pressures and fears in the near term. However, the structural transformation of China's economy from central planning to a market economy still has a long way to go. This will undoubtedly provide opportunities for growth and profits, but will also raise questions of how to pay for the costs of economic reforms and provide risks of policy

mistakes. In particular, the government may try to buy off particular interest groups with preferential policies which are not in the interest of the economy as a whole. In the near term, however, the increased liquidity resulting from any credit easing could well fuel a rerating of China's stock markets, and finance economic growth and earnings growth in the years ahead. However, the continued opaqueness of both macro-economic and company related data and structure necessitate careful due diligence on any investment proposition.

INDONESIA
FINANCE COMPANIES RISE IN IMPORTANCE

Introduction

The nature of the Indonesian banking and finance industry has been changing over the last 2 years. Customers and banks have become more sophisticated in their use of credit instruments and in funding in foreign currencies. This has been part and parcel of the ongoing expansion in credit in Indonesia which started in 1993. The first part of this article reviews the nature of the monetary expansion to date. This puts in perspective the recent rise in reserve requirements. As in Thailand, the monetary authority has preferred to raise financial intermediation costs rather than change the exchange rate regime. Consequently, in the first instance, term lending growth may slow, bank's loans to deposit ratios will decline and borrowing rates will rise. However, over time, a return to direct administrative monetary controls will only lead to more rapid growth in other forms of credit and induce shifts in the instruments or intermediaries of credit. Higher reserve requirements will not restrict the sources of monetary base growth.

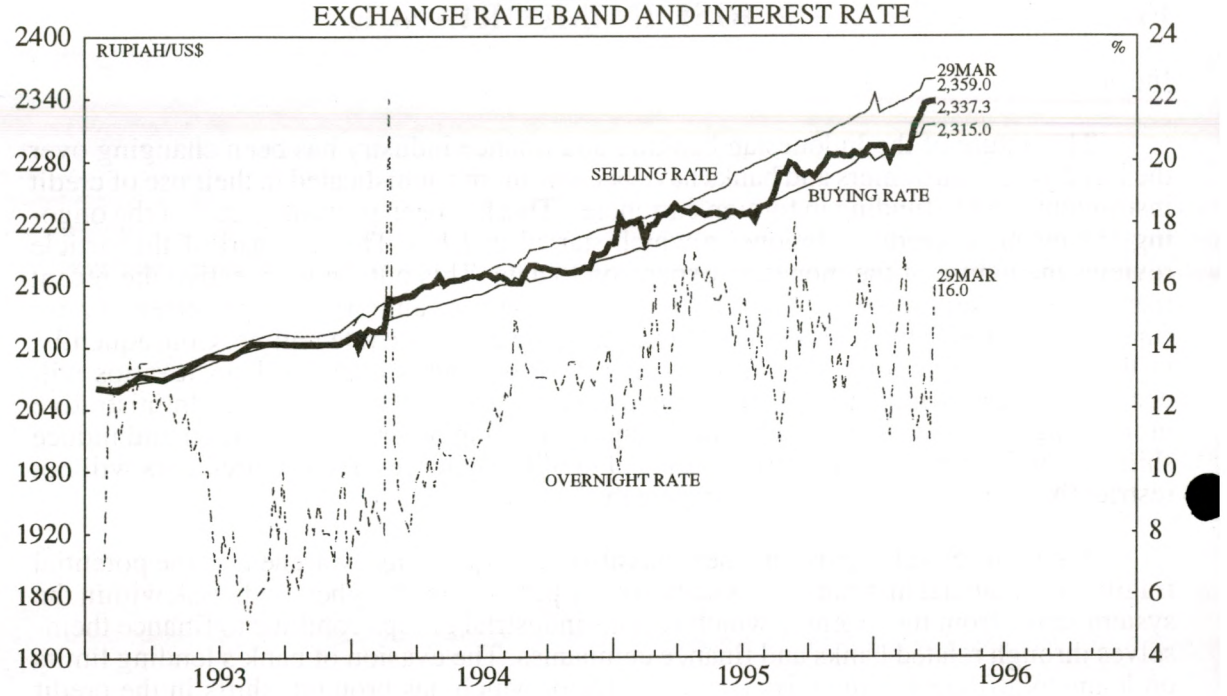
Amid this credit expansion, there has also been a growing awareness of the potential fragility of financial institutions. Essentially, the perception of higher credit risk within the system stems from the extent to which various industrial groups continue to finance themselves through related banks and finance companies. The evasion of bank's lending limits on loans to affiliated companies is another factor which has brought shifts in the credit instruments or intermediaries. Over the past year, the central bank, Bank Indonesia (BI), has become more vigilant and introduced some measures designed to reduce the systemic credit risk in the bank and finance industry. The authorities have set higher capital adequacy requirements for banks and sought to limit the concentration of bank credit to finance companies. In addition, activities of finance companies are now subject to minor controls. The second part of this article reviews these briefly and their likely implications. As one might expect, raising the level of capitalisation of the banks is proving easier than monitoring the concentration of banks' credits to certain areas. Consequently, the risk that problem loans to affiliated companies emerge has not necessarily declined.

A Brief Review and Background to Current Credit Boom.

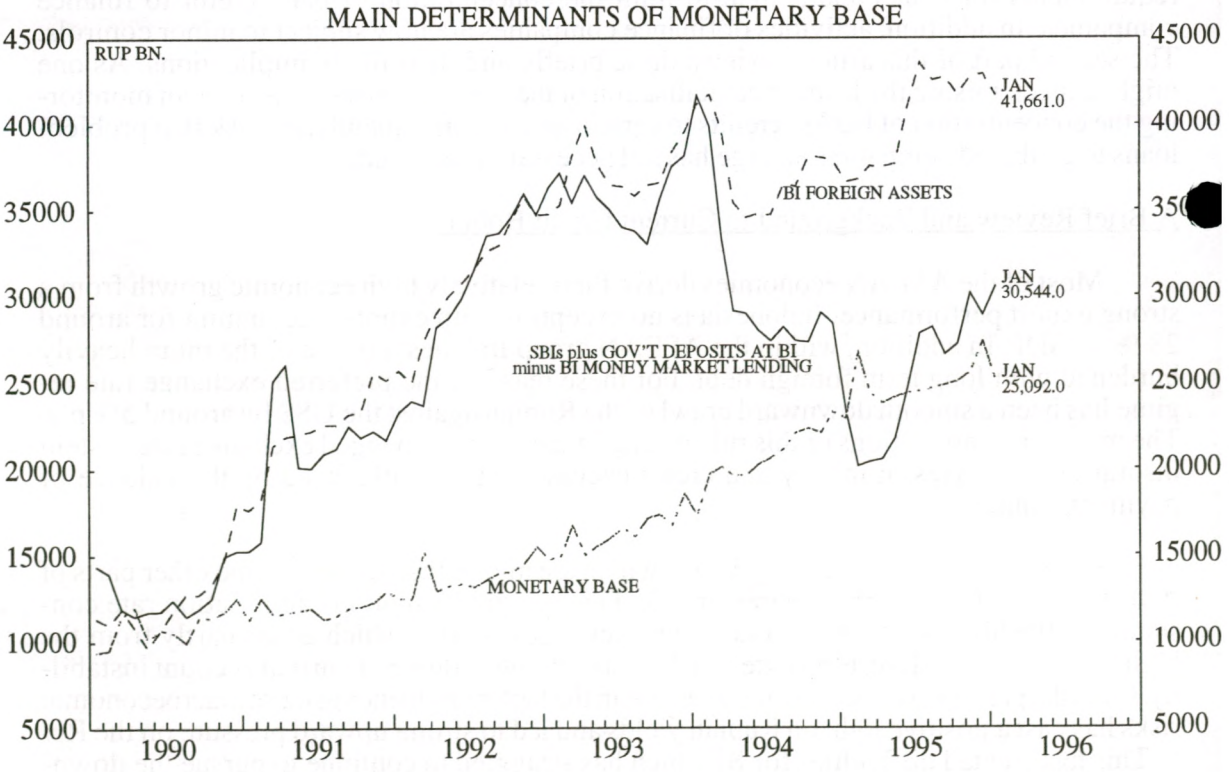
Most of the ASEAN economies derive their relatively high economic growth from a strong export performance. Indonesia is no exception with exports accounting for around 28 % of GDP. In addition, within the ASEAN group Indonesia is one of the more heavily burdened with long term foreign debt. For these reasons, the preferred exchange rate regime has been a smooth downward crawl of the Rupiah against the US$ by around 5% p.a. The monetary implications of this rule resemble those of any pegged exchange rate system insofar as the cycles in money and credit become heavily influenced by the balance of payments condition.

Rupiah financial assets carry yields which are higher than those in some other parts of ASEAN, reflecting a higher degree of risk. This is a function of: (1) an inflation rate constantly in the high single digits and (2) an exchange rate risk which arises partly from the high level of official long term external debt, an ongoing source of current account instability. Over the past few years, any improvement in the factors influencing these macroeconomic risks has cast a positive light on Rupiah yields and led to strong upward pressure on the Rp/$. This has created difficulties for BI which has struggled to continue to pursue the downward crawling exchange rate policy.

INDONESIA: CHART 1
EXCHANGE RATE BAND AND INTEREST RATE



INDONESIA: CHART 2
MAIN DETERMINANTS OF MONETARY BASE



Every day BI sets a mid-rate for the Rp/$ and two intervention limits +/-1.1 % either side of it (chart 1). If the market exchange rate reaches an outer extremity of this band, BI is obliged to intervene. For most of 1995, market pressures had kept the Rp/$ rate on the strong side, frequently requiring BI to purchase foreign exchange to keep the rate below the 'ceiling.' This persisted and held back efforts to tighten monetary policy with other market measures. In order reduce the upward pressure on the Rp/$, yet retain the expectation of a downward crawl, over the years, BI has widened the band width. This has had the effect of increasing the perception that the Rp/$ can move in larger steps, free from official intervention. By allowing the exchange rate to fluctuate to a greater degree within this regime, BI is allowing credit conditions to become marginally less sensitive to strong short term capital movements.

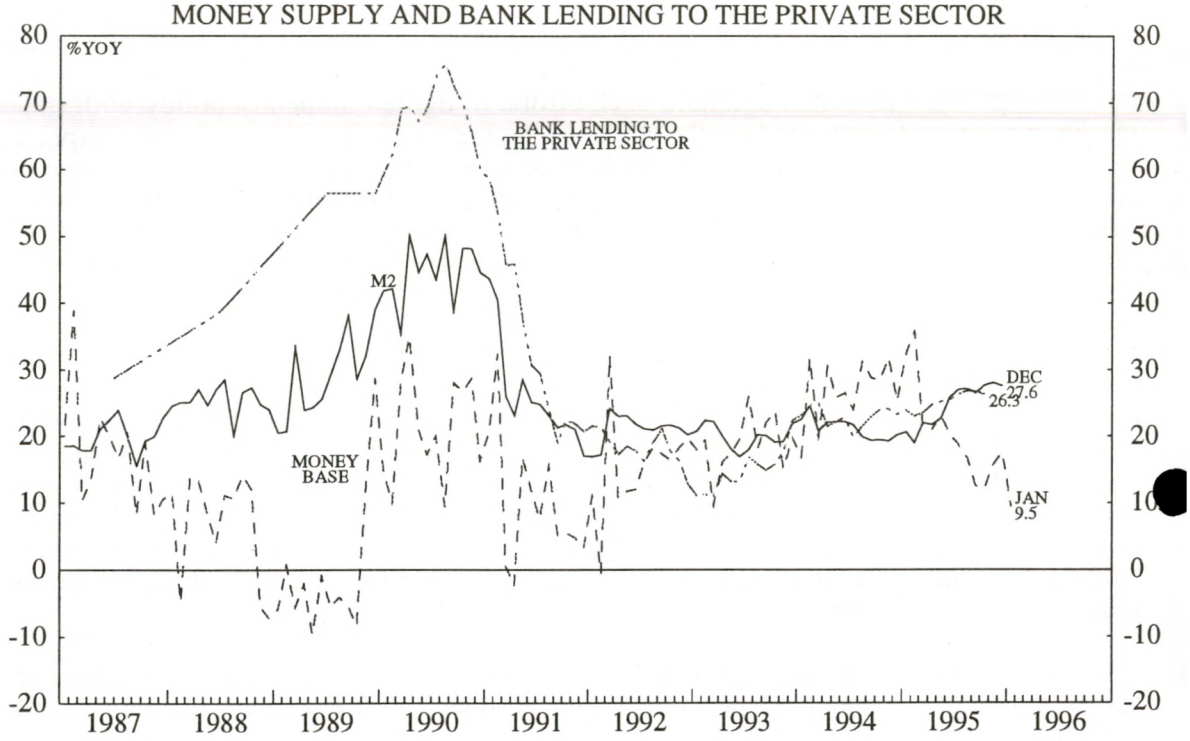
The persistence of capital inflows has meant that Rupiah lending rates to local entities have increasingly been based on the cost of hedging a rupiah asset for a foreign investor. As a result the market for forward exchange rate contracts has become an important (even dominating) means by which foreign capital affects domestic interest rates. In addition, over the last year there has been rapid rate of growth in the use of various types of option contracts. These are typically arranged by foreign banks catering to two types of customer: foreign investors and local borrowers. The first set of customers may seek to enhance the yields on their holdings of short term debt while the second set are on the lookout for cheaper ways to hedge short term borrowings.

Since 1990, there has been a steady accumulation in official foreign exchange reserves although this has become more irregular since 1993. For much of this time the central bank, Bank Indonesia (BI) has to some degree sterilised its foreign exchange intervention with various open market operations. This can be seen in chart 2, where, until 1994, the rise in foreign assets has been mirrored by the rise in domestic open market operations. At the start of 1994, as US rates rose, BI had to act to stabilise the strong downward pressure on the Rp/US$ and this led to a sizable fall in foreign exchange reserves. However, through the course of 1994, BI more than compensated for this short term liquidity squeeze by injecting Rupiah deposits into the banking system. As a result monetary base growth accelerated significantly over 1994.

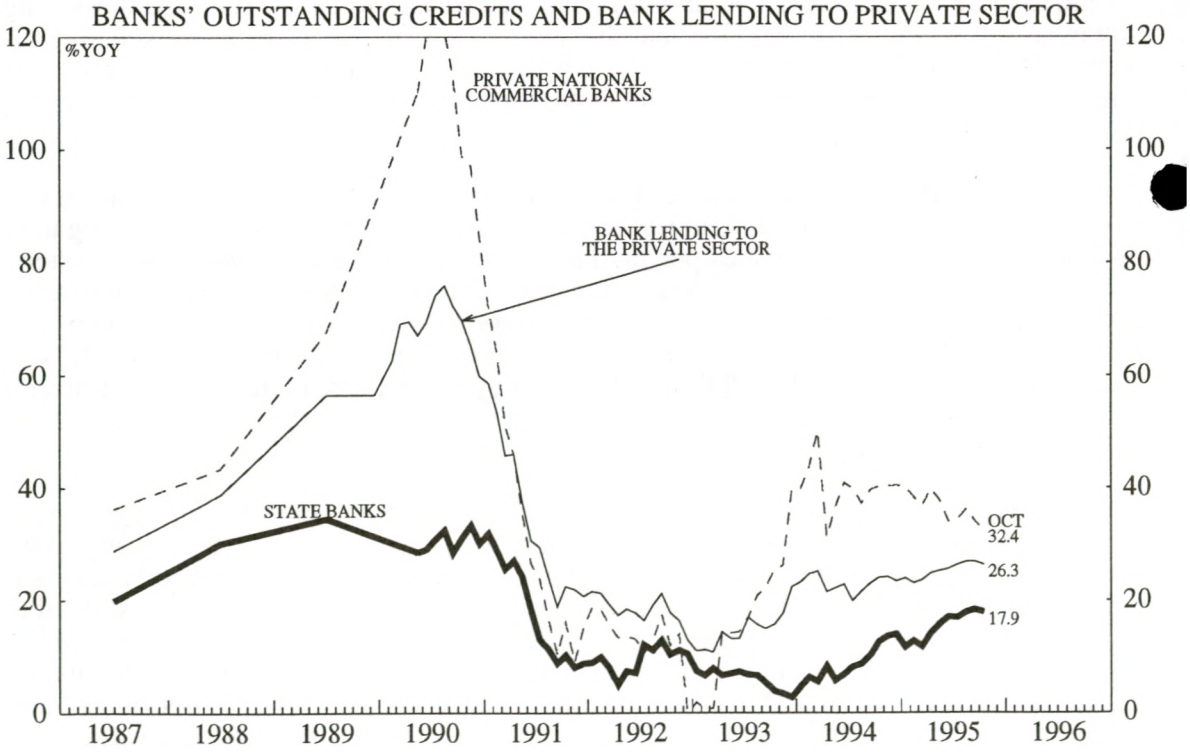
In 1995, after the Mexico-induced tremors in the local foreign exchange market had passed, foreign exchange reserves at BI accumulated rapidly. At the same time BI began to reverse its (stimulative) domestic open market operations. However, it was unable to sterilise completely the expansionary impact of the capital inflows. While the influx of foreign capital was acting to stimulate more rapid monetary base growth, a decline in the use of currency in circulation meant that monetary base growth actually slowed (chart 3). Notwithstanding this, as a result of BI's monetary policy since 1993, monetary conditions on balance, have been very accommodative. Consequently, there has been a long and steady upswing in total credit growth over the past three years (see chart 4).

As has been discussed in a previous AMM (Vol.19 No.4), one of the consequences of the current monetary expansion is the deterioration in the trade surplus. It is important for Indonesia to run a trade surplus so that it can continue to finance comfortably substantial debt servicing obligations. As can be seen in chart 5, in 1995 non-oil exports slowed to low rates of growth relative to import growth, partly due to falling plywood prices in 1995. At the same time imports continued to accelerate in line with the monetary expansion. However, there has been a slowdown of imports since October. This is not due to any change in monetary conditions, but is consistent with a slowdown in both car sales and Japanese exports to Indonesia during this time (chart 6). As a result the trade surplus has

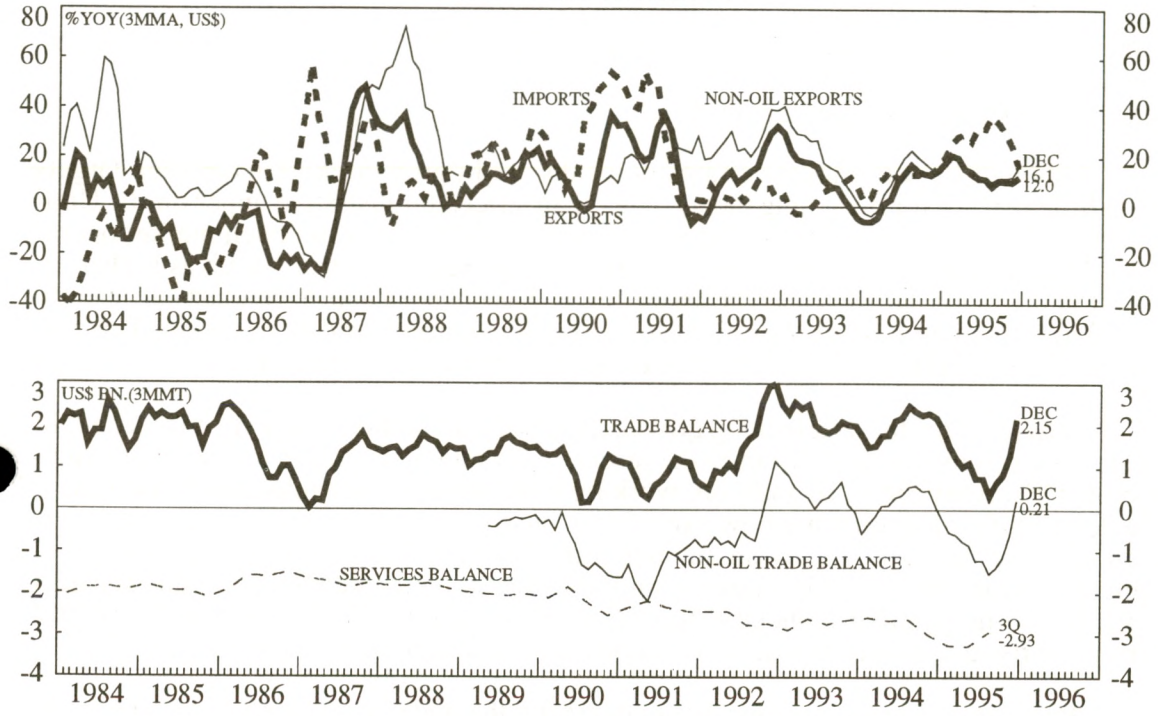
INDONESIA: CHART 3
MONEY SUPPLY AND BANK LENDING TO THE PRIVATE SECTOR



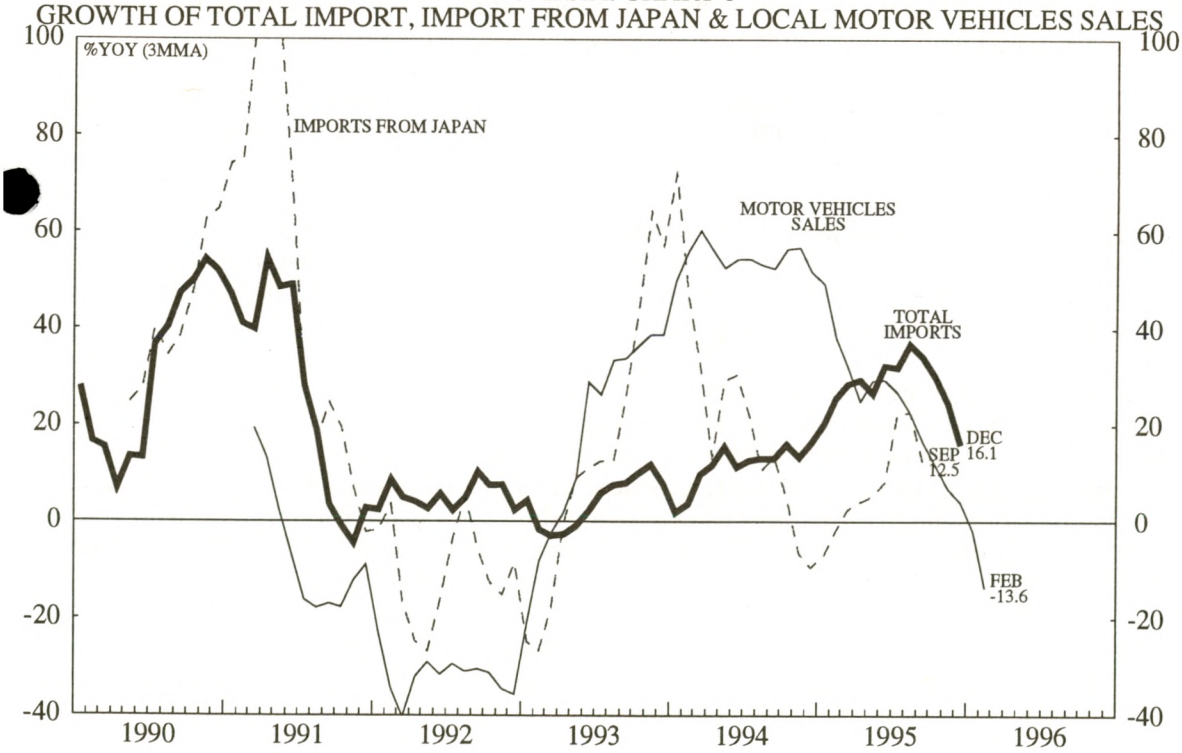
INDONESIA: CHART 4
BANKS' OUTSTANDING CREDITS AND BANK LENDING TO PRIVATE SECTOR



INDONESIA: CHART 5
TRADE PERFORMANCE



INDONESIA: CHART 6
GROWTH OF TOTAL IMPORT, IMPORT FROM JAPAN & LOCAL MOTOR VEHICLES SALES



rebounded. Looking ahead, there is a risk that exports remain depressed, given the subdued pace of US economic growth, and assuming that imports recover their former strength. The resulting trade surplus deterioration would augur for a weaker Rupiah/$ within the band and pressure for higher interest rates i.e. a general tightening in monetary conditions.

A Return to Direct Monetary Control

Although BI sets annual ceilings on banks credit growth, these have been targets (with little penalty for breaching them) rather than strict administrative upper limits. Until recently, BI has used only market based instruments in its domestic open market operations. It has refrained from more direct methods of monetary control—such as higher reserve requirements. However, as shown earlier, BI has not been able to conduct sufficiently tight domestic open market operations to restrain the current credit expansion. The currency regime has effectively constrained the rises in domestic interest rates.

Until recently, the accelerating growth in bank credit remained largely unchecked. In an attempt to stabilise this, BI raised the reserve requirement from 2% to 3%, to be effective on 1 February 1996. In addition, working cash balances of banks which used to be counted in this calculation are now excluded. Consequently, the reserve requirement has risen by more than 1% (i.e. by an amount equivalent to these working cash balances—equivalent to around 1%). This move is similar to that implemented by other central banks in the region in a similar monetary situation (for example in Thailand where the central bank recently raised reserve requirements on non-resident Baht deposits).

Higher reserve requirements do not deal with the underlying cause of the credit expansion even though the growth in bank credit itself could well decelerate as a result. However, if reserve requirements continue to rise, the cost of intermediating funds among the banks will also rise irrespective of how the funds initially entered the system. This will ultimately divert new sources of Rupiah funds away from banks balance sheets.

Banks and certain types of finance company have been limited in their ability to borrow in foreign currencies by COLT (Commercial Offshore Loans Team) which sets an annual limit of $500m. A recent change has meant that all types of finance company are now included within this quota of foreign currency borrowings. As a result, the scope for borrowing in foreign currencies by the whole financial sector is restricted in theory, to the limit set by COLT. In addition, finance companies now come under the jurisdiction of BI (as well as the Ministry of Finance) so the foreign borrowing activities of finance companies will likely come under closer scrutiny.

However, this limit on foreign currency borrowing does not restrict non-resident lending activities to local entities. Promissory notes, such as commercial paper, issued either by the ultimate borrower or by an intermediary such as a finance company have been used increasingly over the past couple of years. They are a natural vehicle to use to access foreign investors who in turn, may be keen to buy short term Rupiah assets (less than 1 year to maturity). There has been a significant rise in the outstanding stock of commercial paper (CP) in issue, some held by non-residents. Estimates of the total amount outstanding in issue by end 1995 range from Rp8tn to Rp15tn up from Rp5tn at end 1994. However, towards the end of last year the authorities introduced certain measures (discussed in next section) designed to improve the quality and transparency of credit risk. Some of these measures are aimed at the activities of finance companies as well.

There are over 250 finance companies currently in existence, of which perhaps 50 are

legitimately engaged in 'finance' rather than being companies which serve mainly as financial intermediaries for related parents. This has been a fairly unregulated (and unmeasured sector) whose funding sources mainly comprise the banks and foreign investors. Finance companies have not been subject to reserve requirements and until recently, some had been free from foreign currency borrowing limits. Consequently, as a sector, they have been used partly as a source of foreign currency borrowing and as a way of circumventing the legal lending limits to affiliated companies which are imposed on banks. The table below compares the total asset growth of finance companies with that across all commercial banks over the last few years.

Table: Total Assets of All Finance Companies and Commercial Banks.

	Finance Companies		*Commercial Banks*	
	(Rp tn)	Annual growth	(Rp tn)	Annual growth
Year end				
1992	9.9	-	180.1	17.6%
1993	11.7	18.2%	214	19%
1994	19.07	63%	248	15.8%
1995Oct	-	-	290	17%

Sources: Bank Indonesia and Ministry of Finance

If the recent hike in reserve requirement hike turns out to be the first in a series of increases, M2 will become a less representative measure of broad money. This is because it will not capture the newly used instrument or source of funding for the new intermediary. At present finance companies are a prime candidate to use as a vehicle for bypassing additional rises in reserve requirements. However, in the recent changes, the finance companies now come under the jurisdiction of BI so the differential in reserve requirements between banks and finance companies may not widen much further.

Some Recent Regulatory Changes

The regulatory changes made last September and December have been focused in three areas: capital adequacy of the banks, commercial paper issuance and the activities of the finance companies. The bare bones of these changes are listed in the three boxes that follow.

BOX 1: CAPITAL ADEQUACY

For paid-up capital and CAR for the existing Foreign Exchange banks:
1) After 2 years the paid up capital must reach Rp50bn and have a 9% CAR
2) After 4 years the paid up capital must reach Rp100bn and have a 10% CAR
3) After 6 years the paid up capital must reach Rp150bn and have a 12% CAR.

Banks which seek Foreign Bank status must have paid up capital of Rp 150bn and have a CAR of 10% in addition to meeting existing criterion.

Bank's lending limit to its parent group company is increased from 10% to 20% of the bank's equity provided that the company is listed (with a free float exceding 30%).

BOX 2: COMMERCIAL PAPER

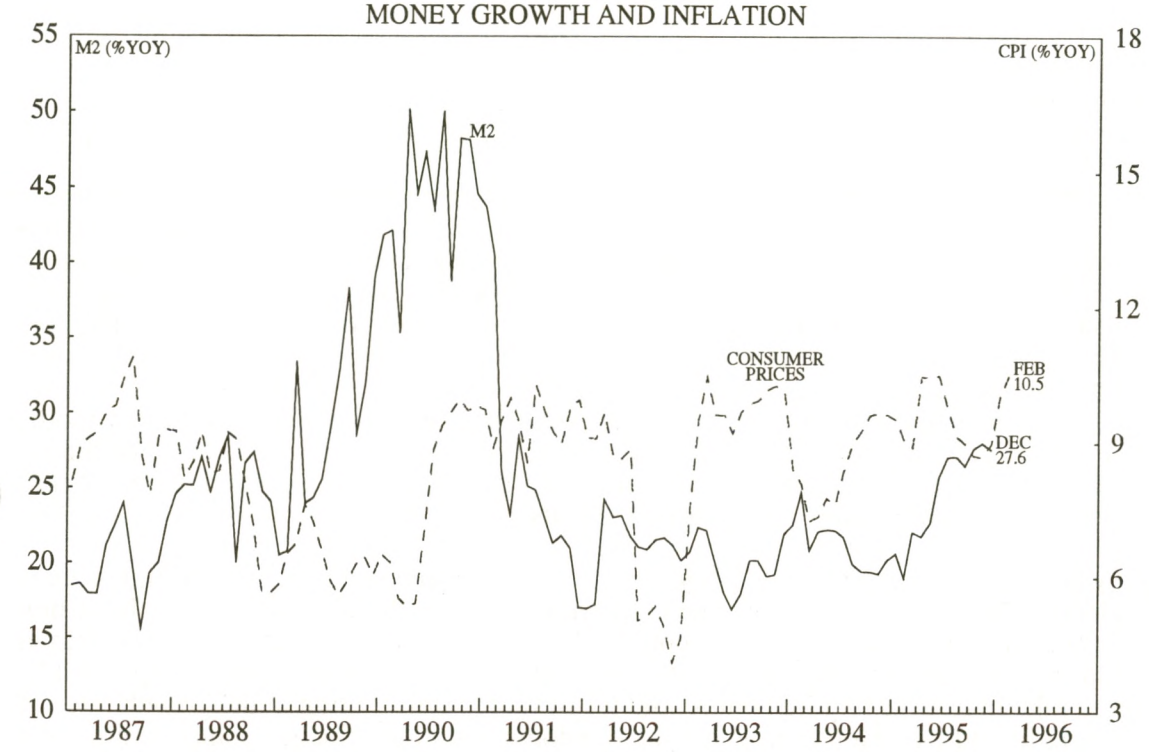
Commercial paper (CP) is a short term unsecured debt instrument issued by non-bank companies with a maturity stretching out to a maximum of 270 days. Although no official record of CP is released, estimates of the total amount outstanding in 1995 range from Rp8-15 tn ($3.5-6.7bn). In general, CP issues have been arranged (though largely not endorsed or underwritten) by banks related to the issuer. For banks, CP carries a 20% risk weighting in the CAR calculation making it fairly attractive to hold from a provisioning angle. From September 1995 onwards, all would-be CP issuers were required to obtain an investment grade credit rating from a registered credit rating agency. PT Perfindo is the only credit rating agency in the country. While it has rated all previous bond issues, the rating of prospective and current CP issuers is still in its infancy. At present, new issues of unrated CP continue to enter the market without the authorities blocking it (provided that it is registered with BI). In December, the authorities issued a regulation preventing banks from holding the CP of an affiliated group, however this does not appear to be adversely affecting their ability to access credit.

BOX 3: FINANCE COMPANIES

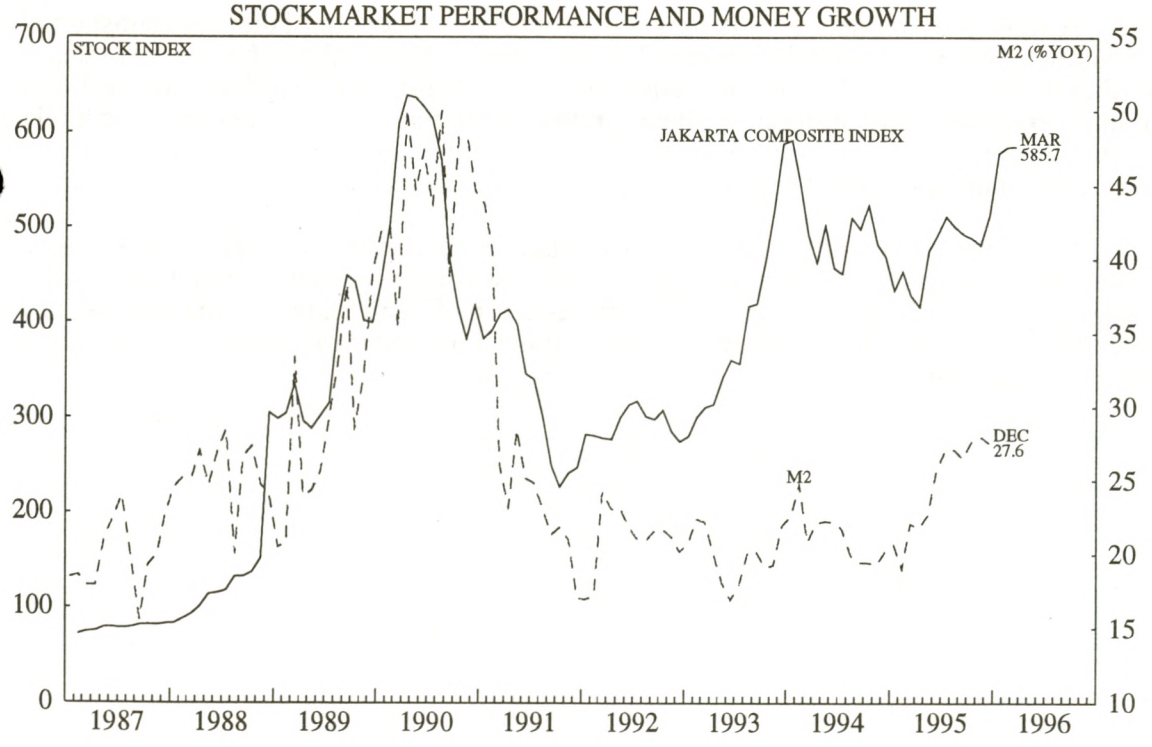
There are over 250 finance companies in Indonesia. Those not acting on behalf of 'restricted parents' engage in four types of credit: hire purchase, credit card issuance, factoring (securitising a receivable), leasing and venture capital. Their main sources of funds are from issuing promissory notes (such as CP, mostly held by local banks), or direct borrowing from local banks and from offshore. By the end of 1994, the total assets of the finance companies came to around Rp16.7 tn (equivalent to 7% of all commercial bank assets). Finance companies are not subject to reserve requirements, net open foreign currency position limits, lending limits, capital adequacy constraints or loan to deposit ratios. However the following changes were introduced last December.

1) No new finance company licenses to be issued
2) Appointment of BI for supervision in addition to MoF
3) Gearing ratio limited to 15 times
4) Offshore borrowing limited to 5 times equity.
5) Direct investments in other financial firms now restricted to 25% of their equity and total exposure to a firm limited to an amount equivalent to 40% of the finance com pany's equity.
6) Finance companies can no longer raise foreign borrowings for affiliated companies. As at the end of 1995, some of the major local listed Foreign Exchange banks did not meet the 9% capital adequacy requirement. Consequently they will need to raise additional capital in the year ahead or slow their loan growth to meet the 9% CAR requirement.

INDONESIA: CHART 7
MONEY GROWTH AND INFLATION



INDONESIA: CHART 8
STOCKMARKET PERFORMANCE AND MONEY GROWTH



With regard to the finance companies, perhaps the most significant restrictions imposed on them have been: (1) a limit on offshore borrowing equivalent to 5 times equity and (2) a maximum gearing ratio of 15 times. However these regulations are minor and are having a limited impact on the activities of finance companies, which hitherto had been largely free from regulation. In addition, the blocking of foreign currency funding to corporates through a related finance company will likely encourage access through less direct routes.

The latest moves to improve credit risk by requiring finance companies to obtain ratings are having a limited effect on their use of CP as a source of funds. This is because unrated finance (and non-finance) companies are still free to issue CP so long as it is merely registered with BI. According to the new rules, banks cannot hold CP issued by affiliated companies. However, this has not adversely affected finance company CP funding programs because for the most part they have been able to sell to non-affiliated banks. Moreover, moves designed to restrict the use of CP would probably give birth to a slightly modified version of it leaving the overall supply of funds (and credit) unaffected. In the longer term, a decline in the concentration of credit on banks' balance sheets must be sought through closer banking supervision arrangements.

SUMMARY AND CONCLUSIONS: The credit expansion in Indonesia continues unrestrained. In the current exchange rate environment this is ultimately driven by the strong influx of foreign capital over the last couple of years. There is little that BI can do to rein in the strong monetary expansion currently prevailing, given their exchange rate regime. The recent hike in reserve requirements could lead to some stabilisation in the growth rates of bank credit and M2. However, given the freedoms within the finance company area, yet higher reserve requirements on banks will likely shift funding away from banks to finance companies and so have little impact on a broader measure of money and credit.

A significant monetary tightening will probably not occur until there is a substantial withdrawal of foreign capital. This could be prompted either by higher US interest rates, a further deterioration of the trade account or by a shock to investor confidence as a result of a major credit default. Of these, the deterioration in the trade surplus appears most likely given the strength of domestic demand relative to that in its major export markets. However, a rebound in plywood prices would put the trade balance in a more positive light.

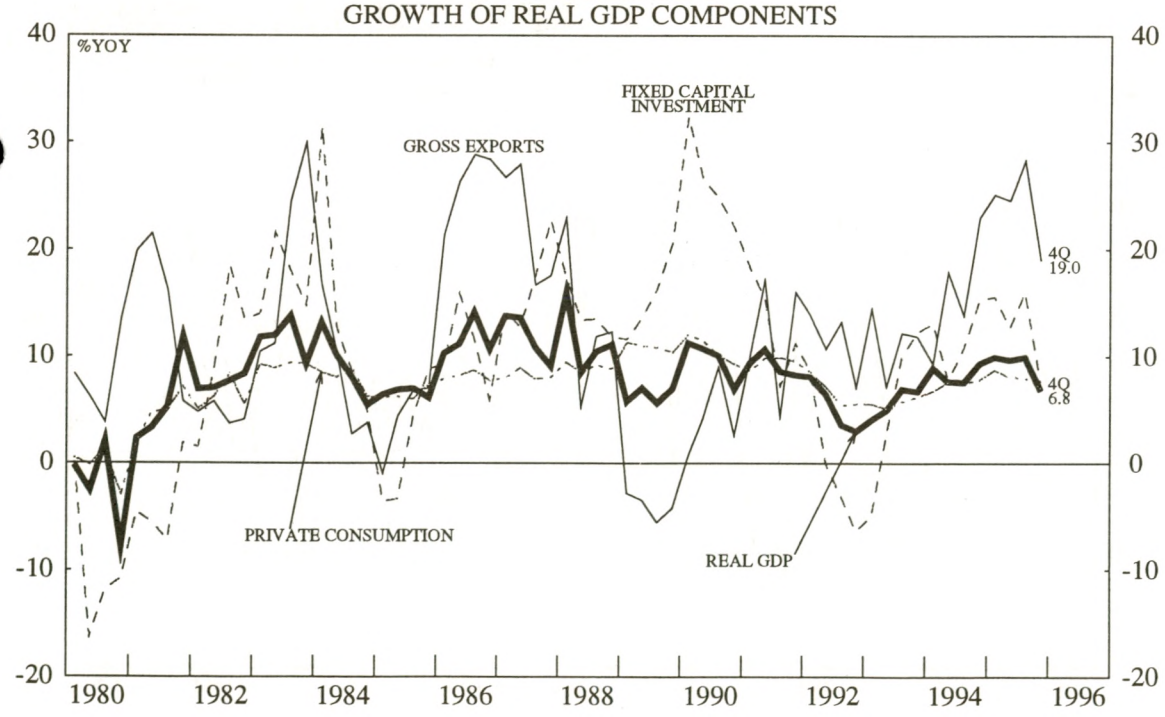
With regard to credit quality, the latest round of regulations will have little effect on either the growth rate or quality of bank and finance company assets. There is a need for closer inspection of the concentration of banks assets by BI and for the credit rating agency to carry out its function effectively. However, it is taking a significant time for the rating agency to get going.

KOREA
LIQUIDITY TO GROW BUT MORE MUTED CYCLES AHEAD

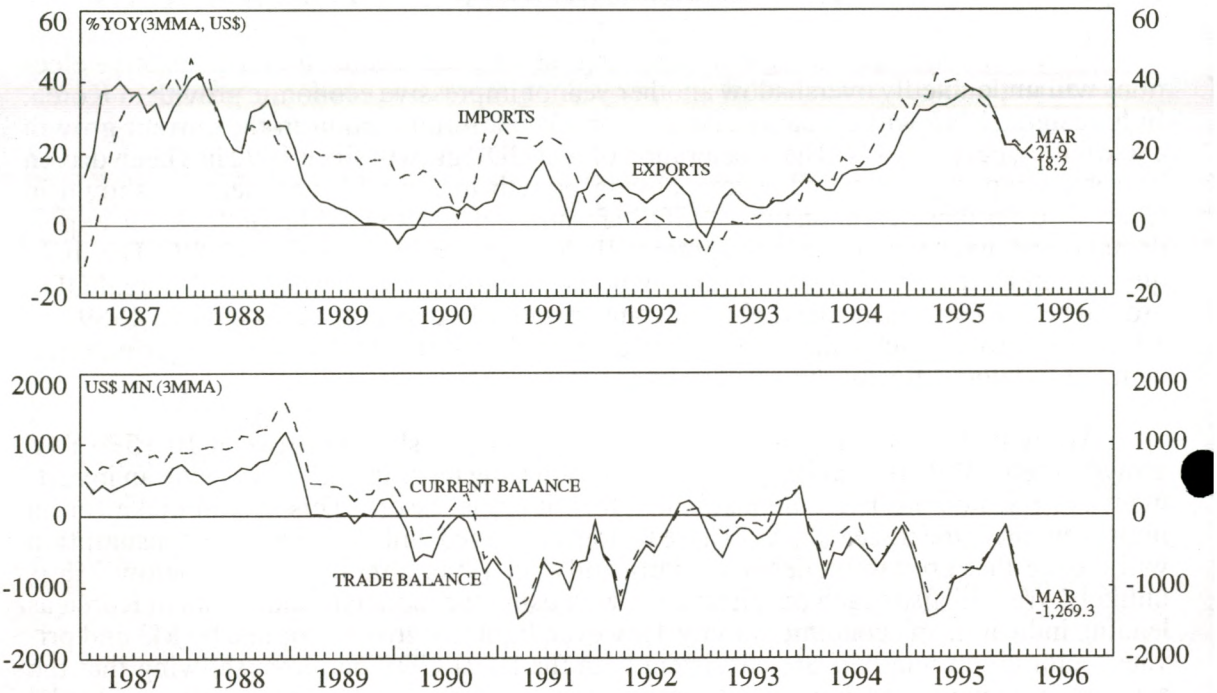
Political noise emanating from ongoing "slush-fund" scandals and legislative elections will undoubtedly overshadow another year of impressive economic growth in Korea. In hindsight, 1995 will probably also have marked a turning point in the current growth cycle dating back to 1992. The acceleration of real GDP growth since 1992 has been driven by robust export growth and accompanying growth in capital investment, as shown in Chart 1. Both these components of GDP are now set to slow as the outlook for export demand and exchange rates looks potentially less favourable going into 1996. The main question in Korea at such cyclical turning points, is whether a "hard landing"- - real GDP growth below 7% - - is the inevitable outcome (exemplified by cyclical troughs in 1989 and 1992). As before, much will continue to depend on the extent of the downswing in external demand and domestic investment activity.

We will show in this article that export growth will slow to between 10-15% YoY growth by end-1996 but capital goods imports will slow more quickly, alongside an investment cycle which has been more subdued than it predecessors. This should make for an improvement in the trade balance. These factors combined with stable private consumption will ensure that growth moderates significantly in 1996, although a drop below 7% is unlikely. We will also touch on difficulties with using the monetary indicators in Korea as leading indicators of economic activity. However, liquidity growth implied by M3 and private sector credit numbers are consistent with the latest GDP outturns, showing that the economy is slowing and liquidity is consequently building up. Prima facie, this ought to be a positive signal for equity markets but the upswing in liquidity is likely to be less intense this time, as Bank of Korea (BoK) policy looks to be attempting to achieve more muted, smoother, growth cycles from here onwards.

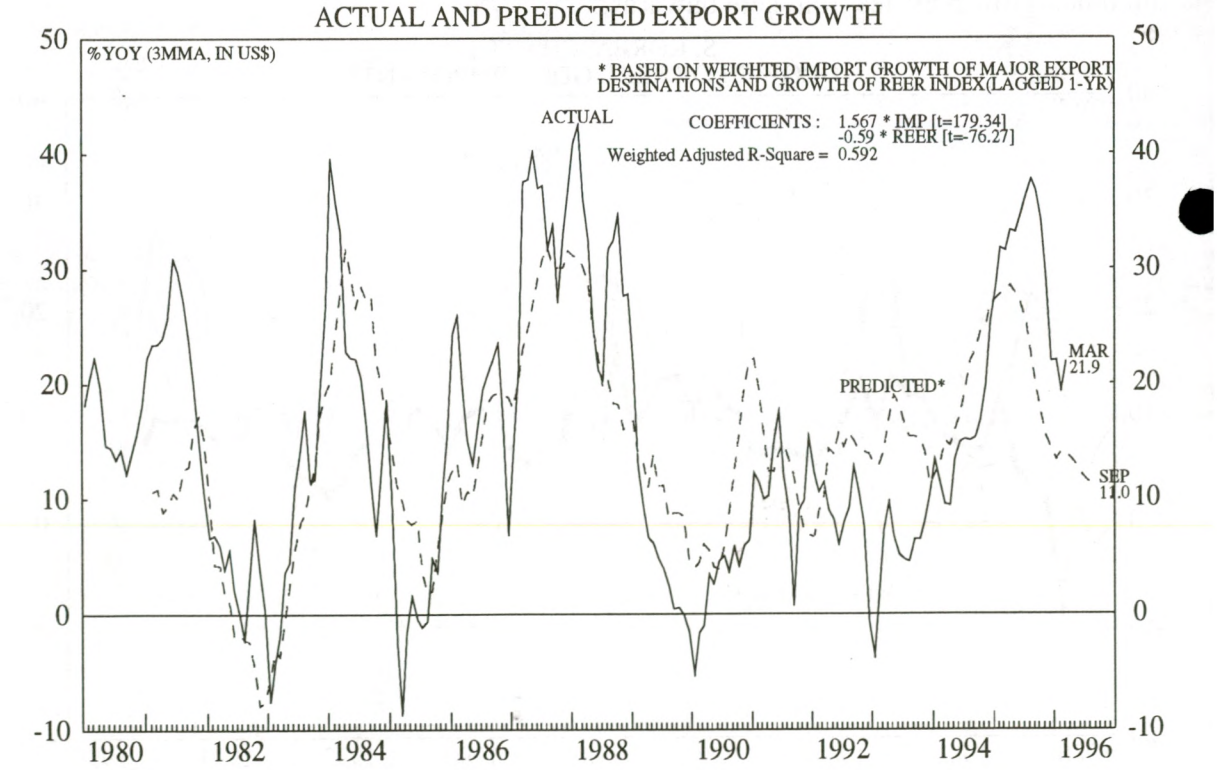
S. KOREA: CHART 1
GROWTH OF REAL GDP COMPONENTS



S. KOREA: CHART 2
TRADE PERFORMANCE



S. KOREA: CHART 3
ACTUAL AND PREDICTED EXPORT GROWTH



Export and Real Economy Trends

Exports, which account for around 30% of GDP, drive the economic cycle in Korea. However, from a structural perspective, the adaptability of the Korean export sector in the face on international competititon is worthy of comment. Over the past twenty years, Korea's gargantuan "Chaebol" corporations have reaped significant market share from diversification into, and economies of scale within, key export industries such as ship-building, car manufacture, and semi-conductors. This ability to transform and adapt rapidly, which has been assisted substantially by government policies, has so far cushioned Koreas trade balance from any major structural decline arising from the demise of its "sunset" industries.

One of the major drawbacks of such massive expansion into export oriented industries at strategic intervals is that Korea has been starved of a domestic capital goods sector. The economy is now unusually susceptible not only to cyclical changes in the external demand environment, but also to rapid deterioration of its trade balance during the early stages of a new cycle (as capital goods imports are sucked in). The coincident movement of exports and imports, illustrated in Chart 2, and consequent deterioration of the trade balance, has been especially pronounced since 1989 following Korea's emergence as a major player in the semiconductor industry.

What drag to economic growth will net exports exert in the forthcoming year? In Chart 3 we reproduce a model of Korean export growth based on changes in the real effective exchange rate (REER) twelve months ago, and a weighted proxy for export demand based on import growth (IMP) in Korea's major export markets. The results of the model, first published in an earlier edition of this publication (AMM, Vol.19, No2), show a relatively good fit over the period of estimation (January 1980 -September 1995), with the correct signs against relevant coefficients, and with statistically significant coefficients in each case. All variables are expressed as 3-month moving averages.

The coefficients themselves show that the effect of changes in the demand for Korean exports (IMP), is more than twice as great as any effect deriving from changes in the REER. Thus a sharp slowdown in Korea's major export markets over the next twelve months could spell a major deceleration in Korean export growth. Our model suggests that Korean export growth will fall between 10-15% YoY by 1996Q3, based on projected IMP growth of roughly 8% YoY up to 1996Q3. If, as we expect, overall economic growth in OECD countries, especially the US, continues to decelerate beyond 1996Q3, then our projection for IMP and, consequently, Korean export growth by end-1996, should also be revised down (a little) further.

Sensitivity to a Slowdown in Export Markets

Exports to the US and Japan account for 30% and 17% of total Korean exports respectively. Other significant export markets include Hong Kong (6% of total exports), Taiwan (4%), Singapore (3%) and Germany (3%). This information allows us to gauge the sensitivity of our export forecast, particularly with regard to changes in import growth in Korea's major export destinations. For instance, assume an extremely pessimistic scenario, where US import growth sinks to 6% YoY by end-1996, and import growth in other major markets slumps on average to 10% YoY (somewhat difficult to imagine for most Asian countries). In that event, the US will contribute 1.8% to total growth of the IMP variable (30 x 6% = 1.8%). Similarly, Japan will contribute 1.7% to IMP (17 x 10%). Summing across all countries comprising Korea's export markets, the variable IMP will be growing

at roughly 5% by end 1996. Finally, assuming a 3% YoY appreciation of the REER at end-1995, total export growth under these extreme assumptions could fall as low as 6% YoY by end-1996 (5% x 1.567 - 3% x 0.59 = 6.1%).

Given more realistic assumptions, however, especially with regard to Asia and Japan, where imports tend to grow at between 15-20% even during slack periods of economic acitvity, total export growth is unlikely to fall below 10% by end 1996. As export growth slows, imports of capital goods to Korea, around 40% of total imports, will slow more rapidly, bringing about an improvement in the trade balance over 1996 as a whole.

Exchange Rates

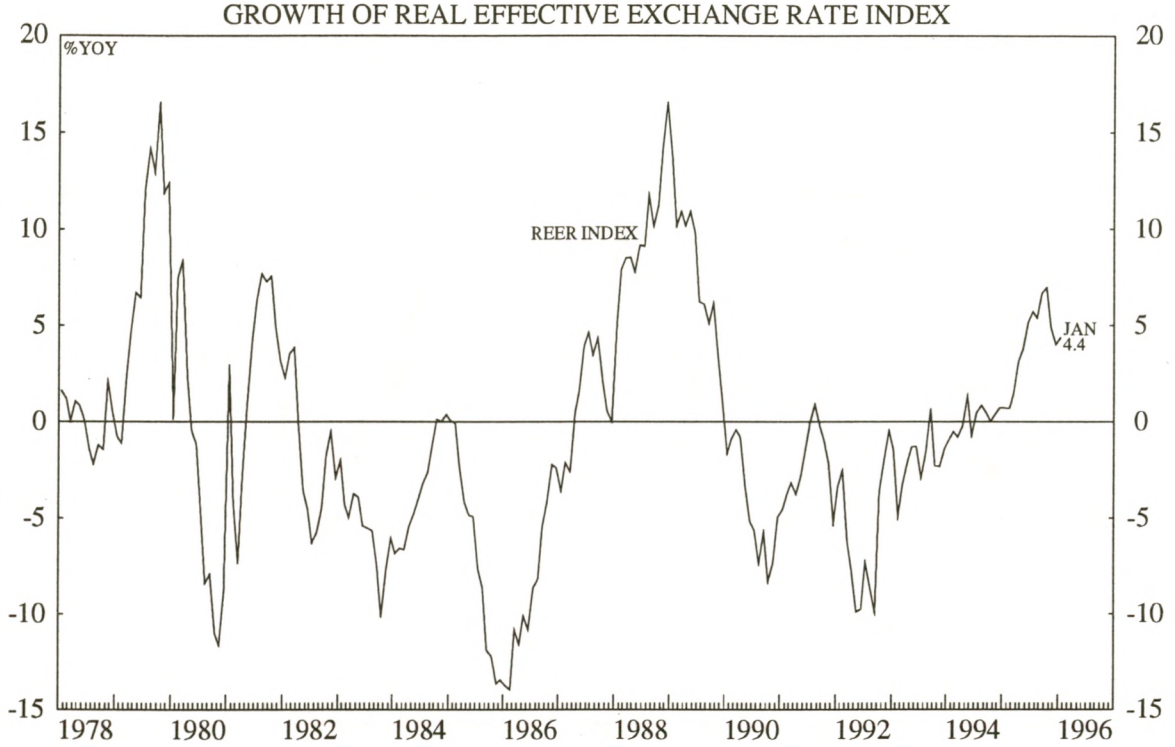
Japan is often cited as Korea's main export competitor so that the $/Yen exchange rate is watched closely as an indicator of Korea's relative export competitiveness. Further sharp depreciation of the Yen against the US dollar in 1996, say by more than 10% from current levels around Y106, could be detrimental to future Korean export activity. The forecast for export activity shown in Chart 3 uses a REER, so that movements of the Yen or the US dollar against the Won are both taken into account. In practice, as shown in Chart 4, the REER has gently appreciated over 1995. In other words, the Korean monetary authorities have allowed a gentle exchange rate "tightening" to filter through in 1995 although the effect is unlikely to have altered the course of export growth by as much as the direction of external demand.

While it would seem consistent that the authorities would have wished to mildly dampen export growth in 1995 through appreciation of the exchange rate, in practice the pressure on the Won to appreciate was dictated much more by capital inflows. Chart 5 shows that while the current account remained in deficit through 1995, dragging the basic balance (capital account plus long-term capital flows) into deficit, substantial short-term capital inflows caused the overall balance of payments surplus to widen.

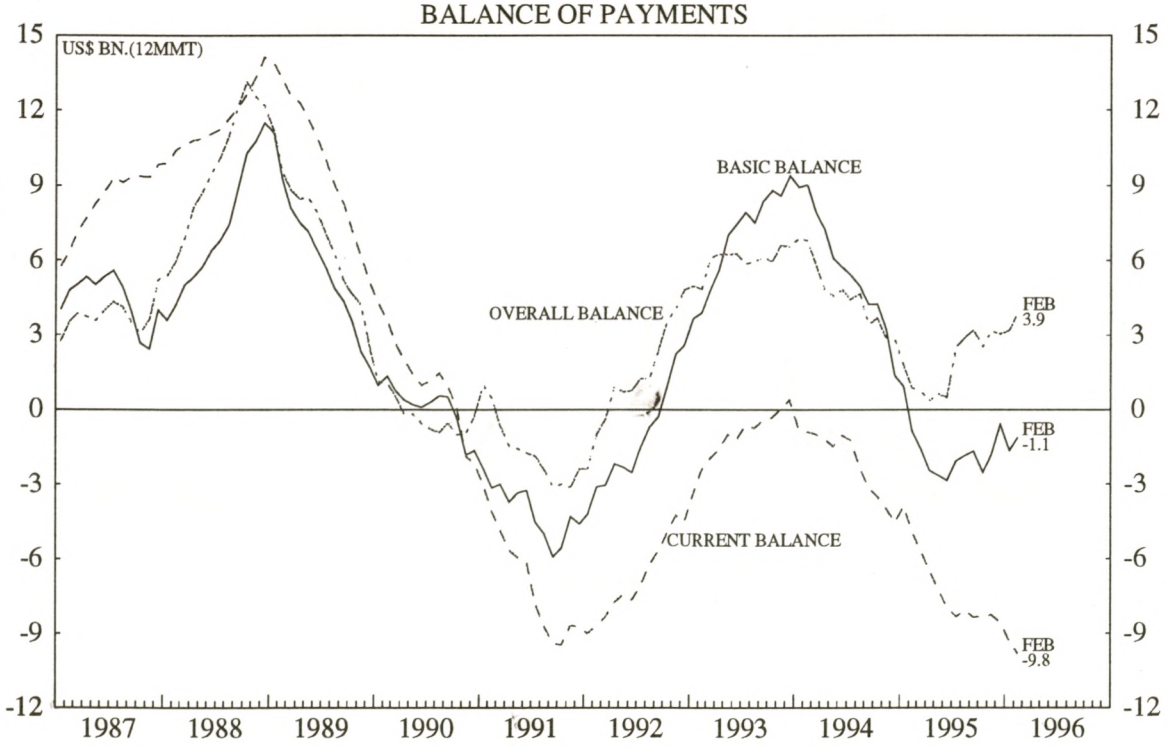
Looking ahead into 1996, exchange rate management will require a difficult balance to be struck between pressure for Won exchange rate appreciation, on account of capital inflows, and the need to resist such pressure in support of the export sector. The authorities may be tempted to lean even harder against Won appreciation this year if exchange rate trends in 1996 are volatile and potentially detabilising; for instance if $/Yen moves abruptly lower. Our foreacast is that the Yen could depreciate to Y115 per US dollar by year end. Such a move may foster concerns, within the BoK, about the negative impact on exports of both a Won appreciation and a Yen depreciation. The most likely and credible response to upward pressure on the Won exchange rate would be to allow the currency to appreciate in an orderly way and thus deter excessive speculative capital inflows. This strategy allows the BoK to pursue its money supply target for the year, without attemtpting to manipulate the exchange rate at the same time.

Thus far we have argued that, under realisitc assumptions about external demand and exchange rates in the year ahead, export growth will be subdued, but not a threat to the soft landing scenario. Indeed, there is likely be an improvement in the trade balance as imports decelerate more rapidly than exports. Growth, however, could be threatened if investment turns down sharply alongside export growth, as in previous cycles.

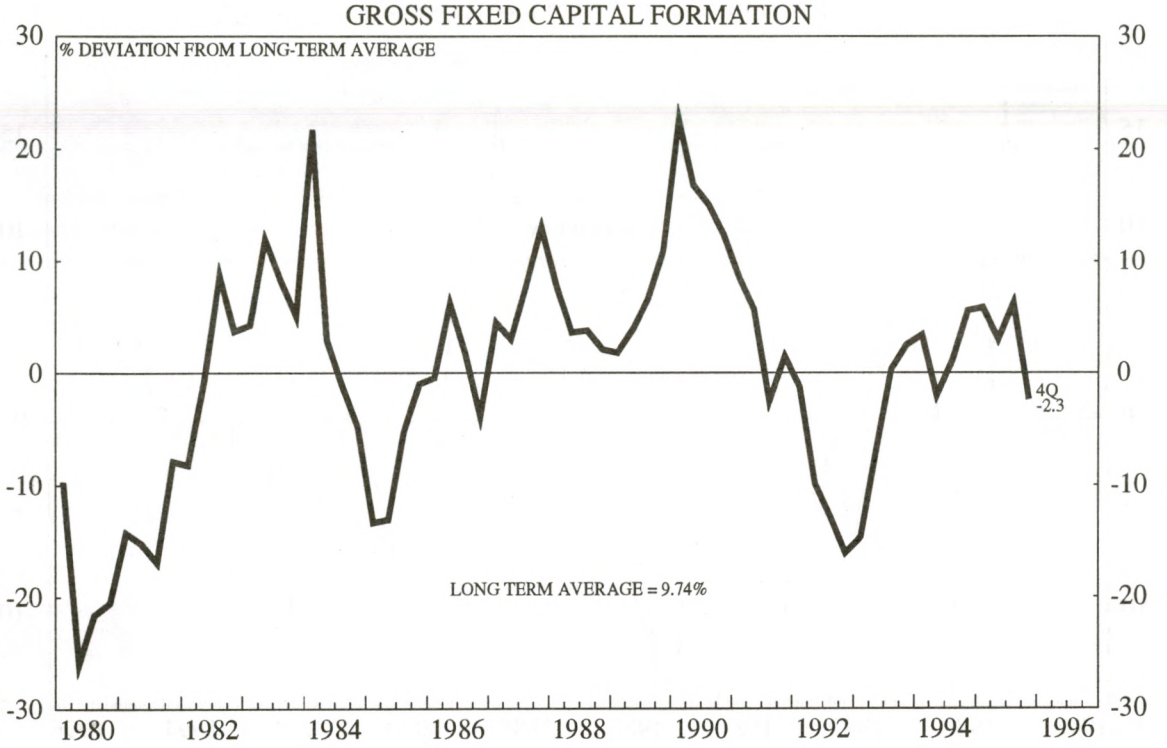
S. KOREA: CHART 4
GROWTH OF REAL EFFECTIVE EXCHANGE RATE INDEX



S. KOREA: CHART 5
BALANCE OF PAYMENTS



S. KOREA: CHART 6
GROSS FIXED CAPITAL FORMATION



S. KOREA: CHART 7
REAL PRIVATE CONSUMPTION AND NON-FOOD CPI INFLATION

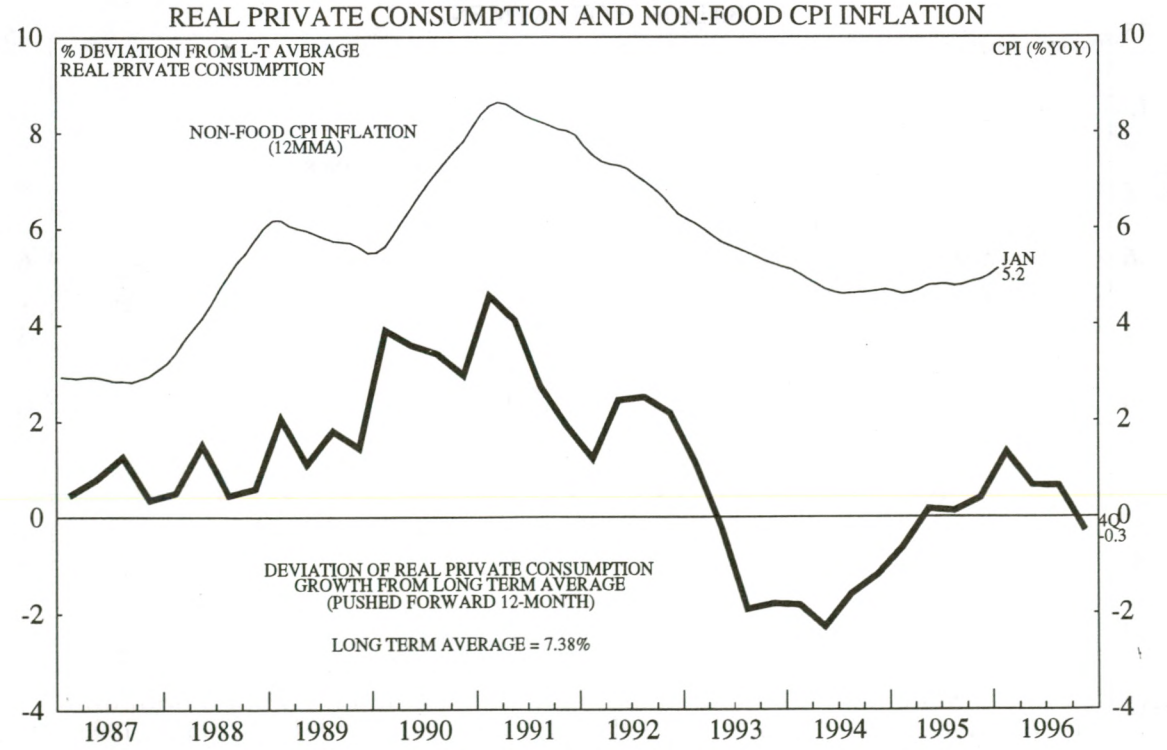


Chart 6 shows the percentage deviation of Gross Fixed Capital Formation (GFCF) from its long run average covering a period of fifteen years and three previous economic cycles. GFCF in this case includes construction and facilities investment in plant and machinery. The chart shows clearly that the tendency to "overinvest" during the upswing of each economic cycle did not feature this time. The the downturn in GFCF can, therefore, be expected to be equally subdued. Within the total, facilties investment is most closely related to export activity and should remain weak as a result. On the other hand construction activity will probably gain momentum, especially with elections looming, as large scale government projects such as the new airport, high speed rail-link, and highways, are given fresh impetus.

A similar analysis can be applied to real private consumption (see Chart 7) which contributes around 60% of GDP. Private consumption in the chart has now returned to its long run average rate of growth around 7.4% YoY, but the BoK will probably be watching this indicator closely to ensure that inflation pressure remains under control. By pushing "excess" real private consumption forward by four quarters, Chart 7 highlights the close link with average core (non-food) inflation. The BoK should be engineering monetary policies to ensure that real private consumption remains at, or perhaps just below trend, especially at a time when wages are growing at around 13% per annum in nominal terms.

Could an inventory correction dampen growth significantly? According to the published BoK inventory index such an outcome would seem unlikely. It appears from Chart 8 that the build-up of unsold inventories has been somewhat slow given the steady acceleration of real private consumption since early 1993. Nevertheless, the inventory index is now at its 1992 rates of change. If our expectations for a reversion of real private consumption to trend growth rates, or just below, is realised, then the inventory correction, and domestic production cutbacks should not be as sharp as in 1992.

Trends in Liquidity

While the banking system is now emerging from years of government policy domination to become more market driven, the overhang of "policy loans" within Korean banks' balance sheets distorts traditional monetary analysis. This is because credit growth, one of the key determinants of money supply growth, has in the past been directed by government policy rather than banks' profitability considerations. Moreover, examination of trends in the money supply is hampered by the existence of large "kerb" markets in Korea. Unofficial credit can still be obtained, and deposits placed, at higher black market interest rates. The flow of kerb market funds into and out of the official banking system, depending on relative yields in kerb and official markets, renders the broad money supply somewhat interest rate sensitive, and consequently less useful as a forward-looking indicator.

The two main Korean money supply indicators are shown in Chart 9. The BoK has adopted M2 growth as its main monetary target, mainly because it is the only (broadish) monetary variable fully under its control, and available on a timely basis. At a cursory glance the lags between M2 acceleration and the subsequent pick up in nominal GDP growth, illustrated in Chart 9, appear to be very short (see for instance 1982, 1987, 1989, and 1993). The speed of transmission between M2 and nominal GDP should not be surprising given that, until recently, credit growth has been very specifically directed by Government policy to encourage growth in certain sectors of the economy. Moreover, Government policy action in the past has an occasions sought to boost M2 growth directly. In 1989 for instance, the acceleration in M2 was due to a government program of explicit stock market support. In 1993, M2 was boosted to support liquidity in the wake of the imposition of

"real-name" bank accounts. Nevertheless, the pattern of nominal GDP and money supply growth shown in Chart 9 suggests that these episodes of policy induced monetary accelerations tend inevitably to result in inflation after a short lag.

The announced M2 target growth rate for 1996 is 11.5-15.5%. Latest data for February show that M2 is already accelerating towards the upper end of the BoK target band. Given the short transmission lags, growth in M2 will need to be carefully monitored in the year ahead if inflation is not to be given renewed upward momentum by the end of 1996.

The stock of M3 is more than 3 times larger than the stock of M2 and performs better as a leading indicator of liquidity, although, it is published only after a considerable lag. The behaviour of M3 as an indicator of liquidity is worth exploring a little further. In Chart 10 we show the absolute change in the stock of M3 less absolute changes in the stock of private sector credit from the financial sector (this sum is simply an alternative way of expressing the loan to deposit ratio of the financial system). The indicator should be broadly countercyclical to the extent that a dowturn in economic activity will result in lower lending growth and eventually a net build-up of M3; the latter in turn is available for deployment in other liquid assets. The benchmark corporate bond yield is also included on the chart as a proxy for other assets in the financial system, and the extent to which these have to compete for any excess/shortage of liquid funds. Clearly when the liquidity indicator is in the negative region corporate bond yields should be rising as the competition for residual liquidity in the financial system intensifies. Alternatively, corporate bond yields can be expected to fall when there is a surplus of liquid funds, indicated by the solid line in the positive region.

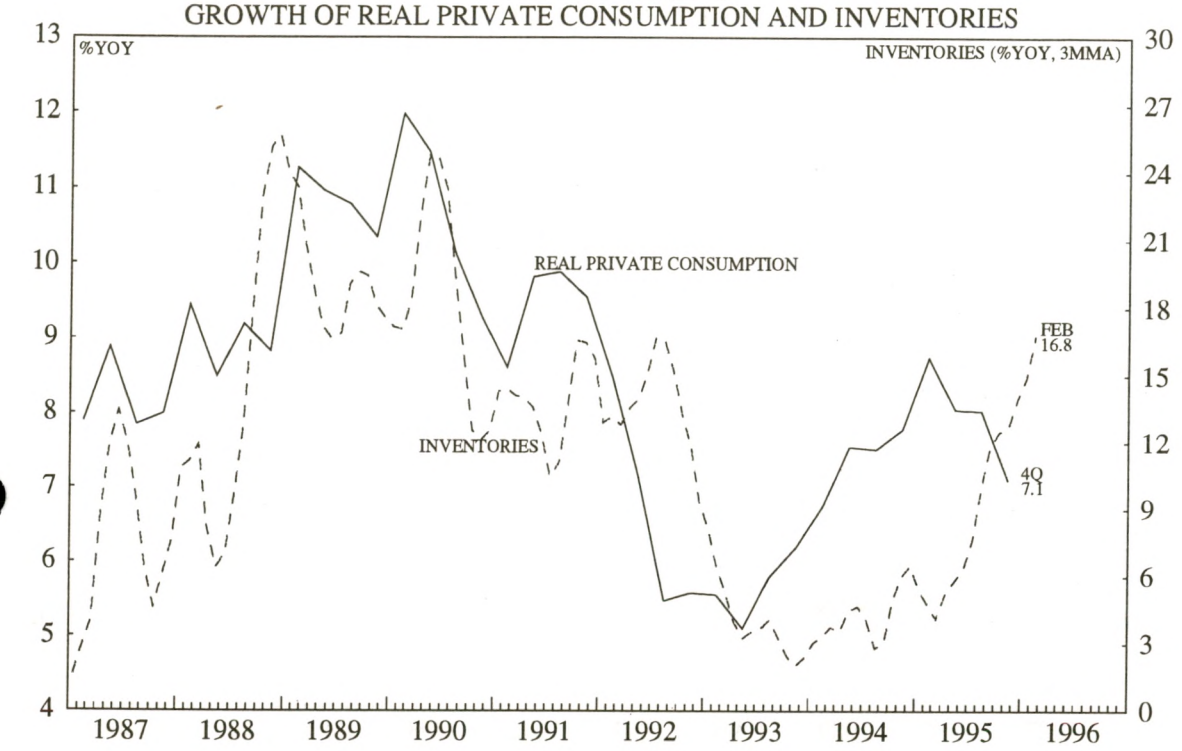
Chart 10 shows that private sector credit extension has been slowing relative to M3 growth since mid-1995. By November 1995 the liquidity indicator was positive, marking a clear excess of M3-type deposit growth over and above private sector credit extension. This pattern of liquidity growth was broadly consistent with the deceleration in economic activity during 1995Q4 shown by the real GDP numbers. As demands from the real economy continue to diminish, liquidity should be expected to grow more positive in 1996.

Actions of the BoK

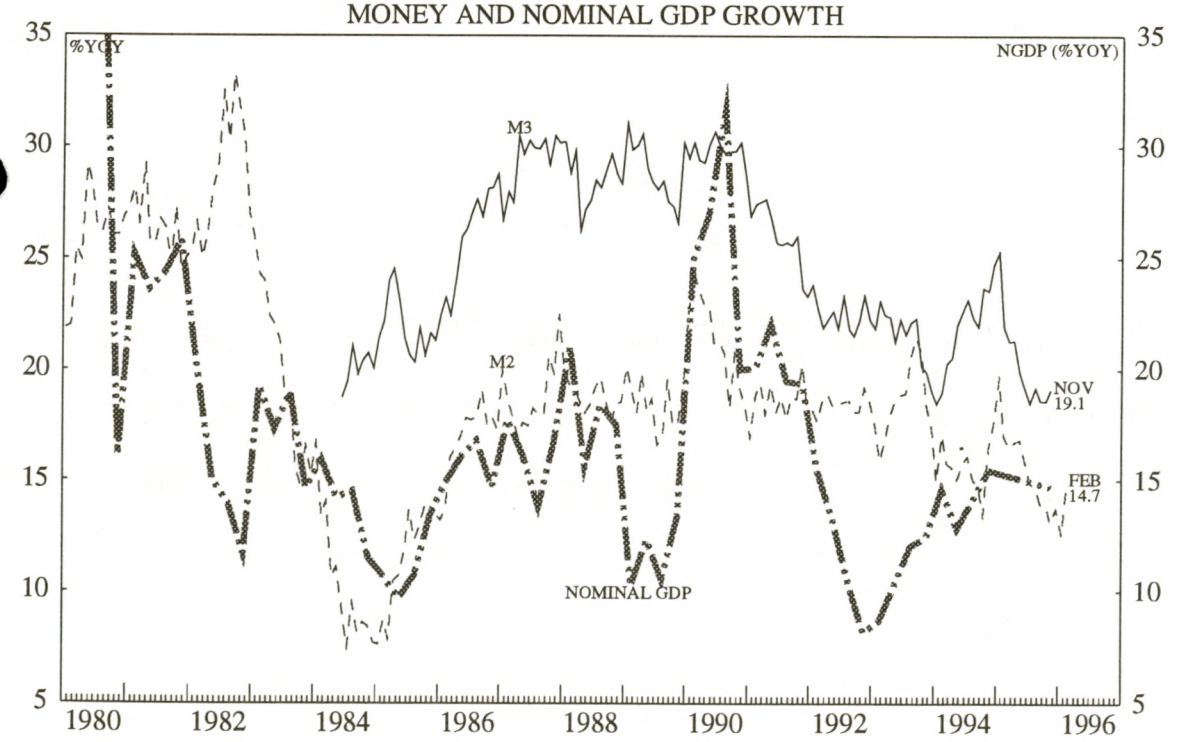
Liquidity growth will be exagerrated in 1996 if the Bank of Korea allows the accumulation of foreign assets, from an improving trade balance and ongoing capital inflows to feed into the financial system. On this issue, the evidence is less conclusive. The gradual opening of the capital account has presented a challenge to the monetary authorities which is demonstrated clearly by the problems faced during the export boom of 1986-1989. A number of measures were taken during that period to sterilise the massive growth of domestic liquidity, including the raising of interest rates and reserve requirements. However, the main sterilisation instrument was the Monetary Stabilisation Bond (MSB). According to the Bank of Korea:

"...they have played an important role since their introduction in controlling the reserve positions of banking institutions. For example, the bank issued MSBs on a large scale to absorb the vast expansion of the money supplied through the foreign sector in the 1986 to 1989 period when the current account ran a substantial surplus. However the use of this instrument revealed its own limitations as increasing interest payments on MSBs themselves served to increase the money supply..."
(FINANCIAL SYSTEM IN KOREA-1995 pp14: Bank of Korea)

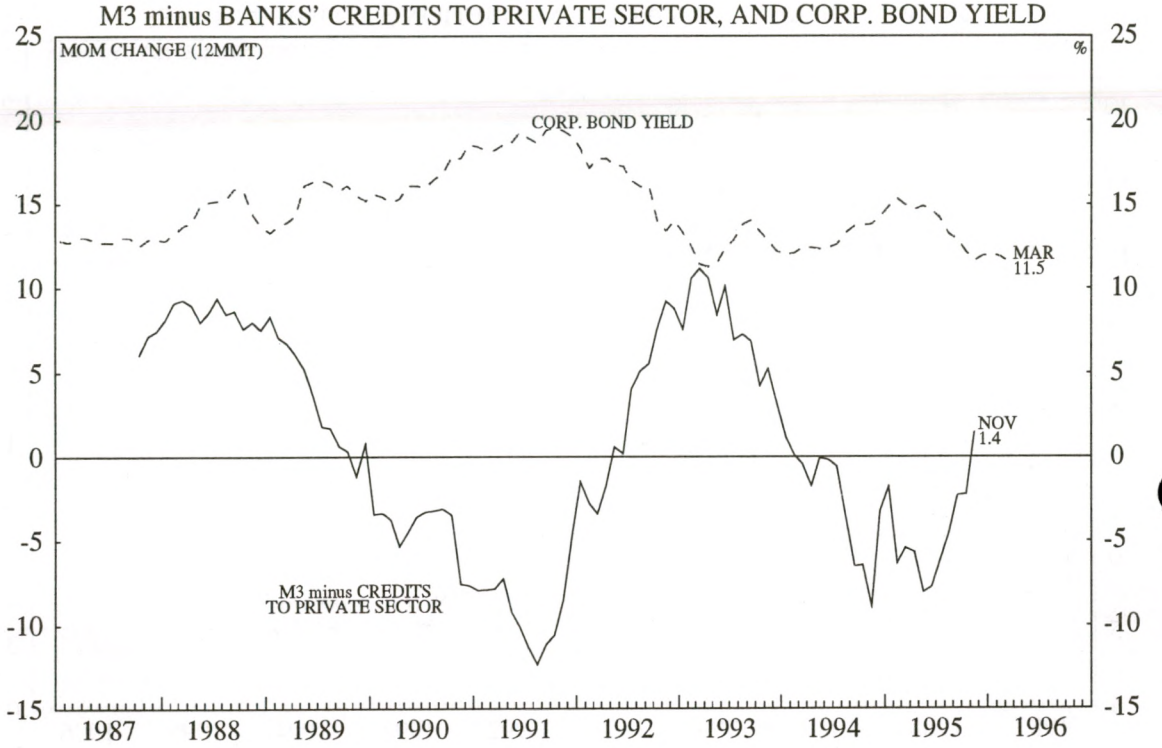
S. KOREA: CHART 8
GROWTH OF REAL PRIVATE CONSUMPTION AND INVENTORIES



S. KOREA: CHART 9
MONEY AND NOMINAL GDP GROWTH



S. KOREA: CHART 10
M3 minus BANKS' CREDITS TO PRIVATE SECTOR, AND CORP. BOND YIELD



S. KOREA: CHART 11
BOK'S FOREIGN ASSETS AND MSB ISSUED

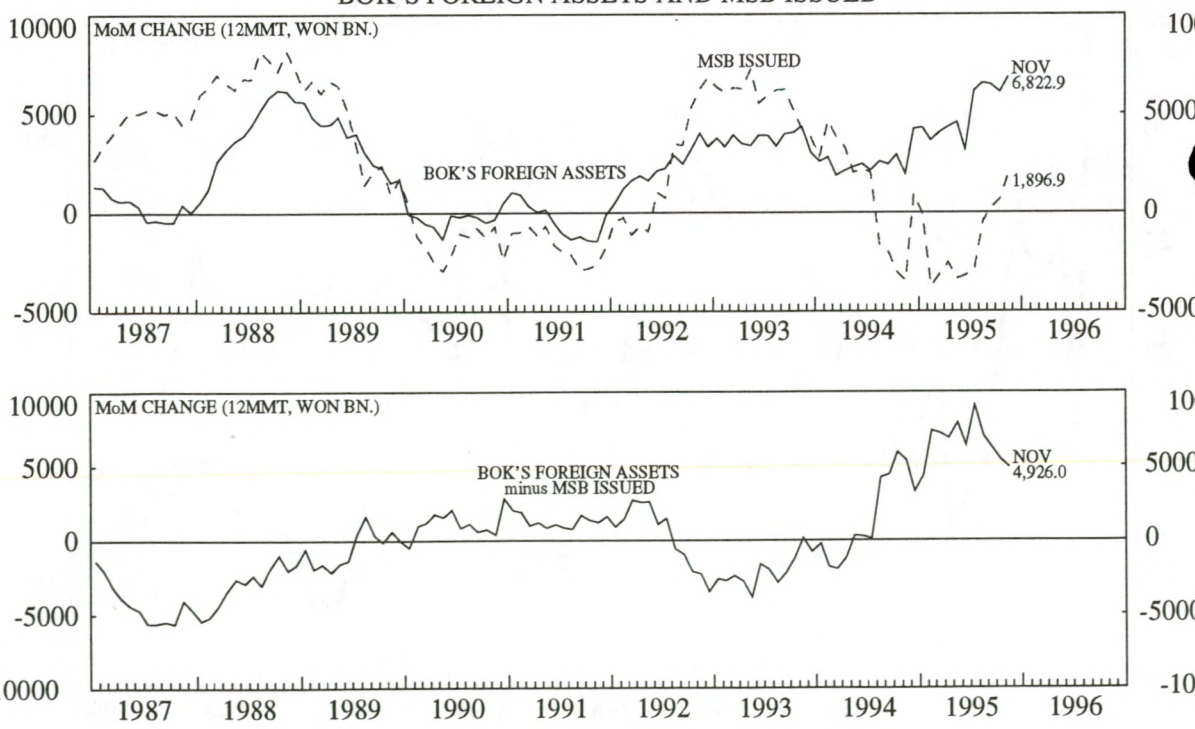


Chart 11 shows changes in foreign assets at the Bank of Korea and net sterilisation of foreign inflows through the issue of MSBs. It appears that over 1992 and 1993 the BoK issued far more MSBs than were needed to fully sterilise the capital inflow during the period. By mid 1994, however, the BoK started to retire its outstanding MSB issues, despite ongoing capital inflows, allowing liquidity to grow rapidly through most of 1995. The BoK has once again started to sterilise the growth in foreign assets in late 1995 although liquidity expansion over 1995 as a whole, purely as a result of capital inflows, remains substantial.

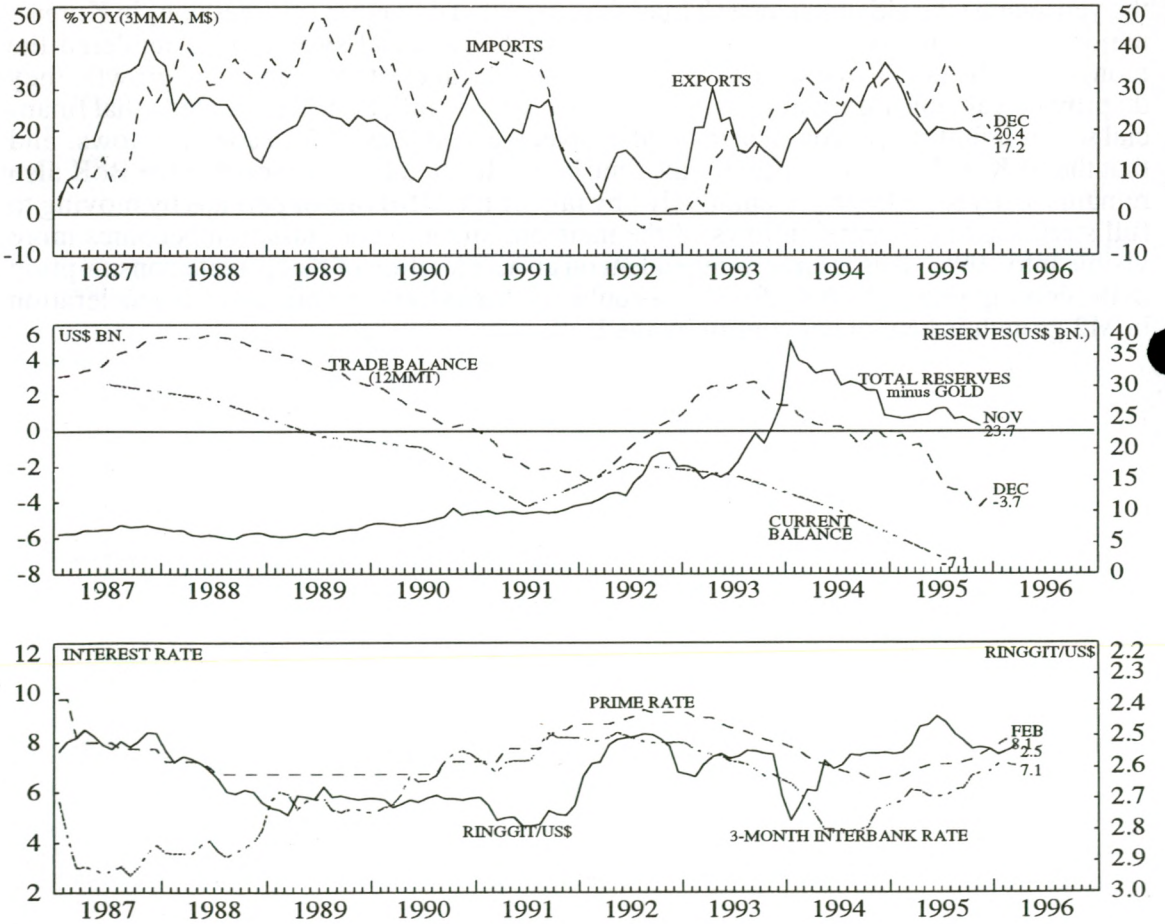
The return of the BoK to using "sterilisation" techniques for the time being represents a policy to lean against, but not to altogether eliminate, liquidity growth arising from capital inflows. In that sense, the BoK's monetary policy stance can be characterised as "neutral to mildly expansionary". Nevertheless, the BoK are likely to be mindful of the re-acceleration in M2 that has come about as a result of capital inflows. A pre-emptive tightening towards the year-end, or early next year, therefore, cannot be ruled out in the event that (above-target) M2 growth begins to threaten the inflation outlook.

SUMMARY AND CONCLUSIONS: We have shown in this article that the downturn in Korea's current growth cycle has already begun and that a soft landing will be the outcome. Export growth will decelerate steadily over 1996 but the dowswing in investment will not be as acute as in previous cycles. We forecast export growth in Korea will be 10-15% YoY by end-1996. The main risks to this forecast lie in the event of further sharp depreciation of the yen against the US dollar, or a sharper than expected downturn (ie recession) in Korea's major export markets. While distortions within the financial system have rendered the monetary indicators less useful as forward-looking gauges of real economic growth, they do provide valuable information on liquidity growth and inflation. We conclude that financial sector liquidity will continue to build up over the next year, as the economy slows, and that the BoK will remain neutral for the time being. It is likely, however, that the BoK also remains ready to squeeze pre-emptively (by raising the MSB rate or perhaps by moving to full sterilisation of capital inflows) if the incipient threat to core inflation becomes more visible into 1996. This is largely dependent on an acceleration of real private consumption in the coming year; which we forecast as unlikely for as long the ominous re-acceleration in M2 growth is kept under control by the BoK.

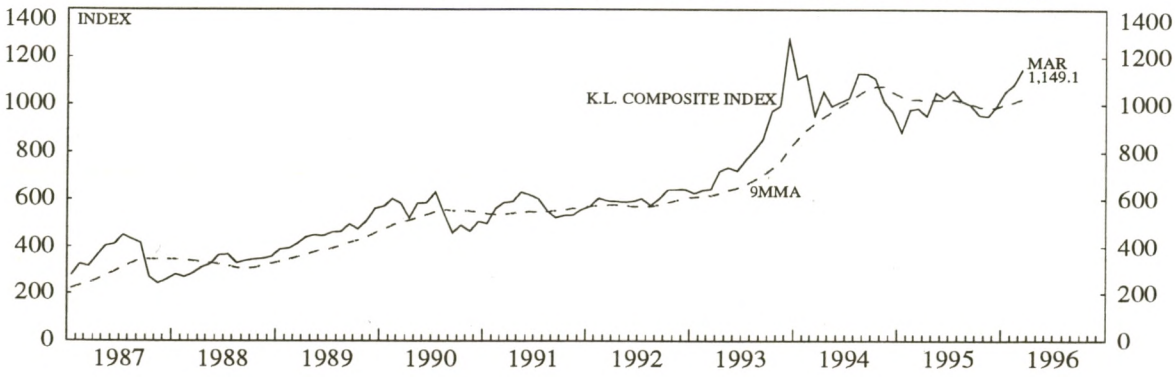
MALAYSIA: CREDIT GROWTH TO TURN THE CORNER

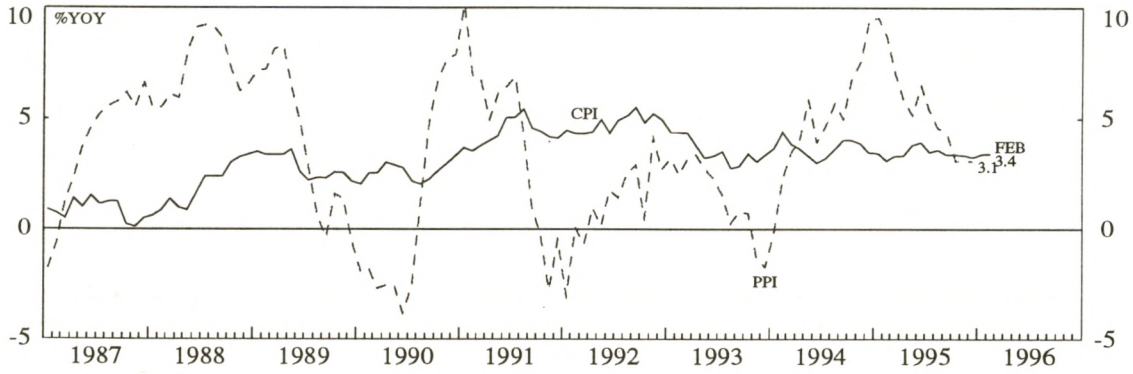
Total credit growth accelerated vigorously in 1995, pushing up M2 growth to 25% in January. Domestic demand has also been strong, reflected by the 9.2% growth in real GDP and persistently high industrial production growth. For most of 1995, import growth outstripped that in exports and so the merchandise trade deficit widened. The current account deficit has followed suit. This deterioration has led to episodes of heavy foreign exchange intervention by the central bank (BNM) followed by some increase in local interest rates to stabilise the M$. Consequently the stock of official foreign exchange reserves has been depleted. At the same time monetary conditions have been relatively unaffected by this foreign exchange intervention because other domestic liabilities of BNM to the banking system have been allowed to mature unrenewed. At the time of the latest interest rate rise, last January, BNM raised reserve requirements by 1% to 12.5%. This step will help rein in the loose credit conditions this year, although total credit growth itself is unlikely to slow until interest rates move higher. Headline CPI inflation rates have not yet responded to the current monetary expansion, although accelerating inflation has appeared in other areas such as manufacturing labour costs.

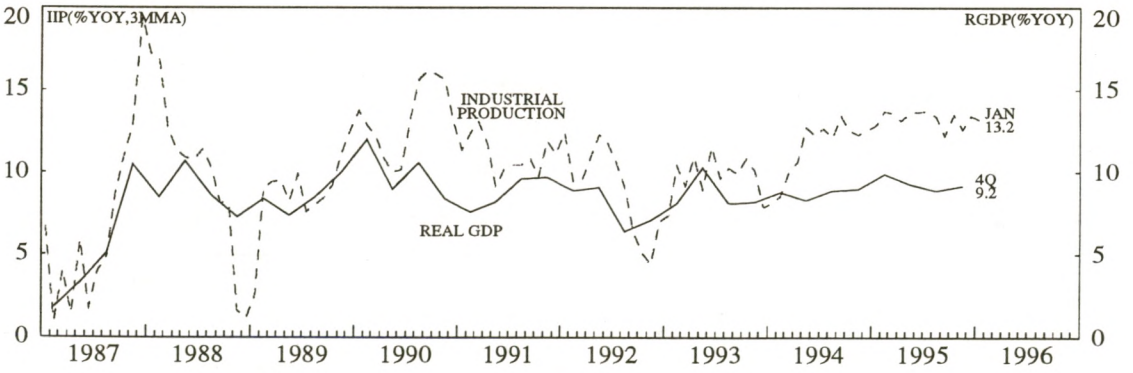
MALAYSIA: MONEY MARKET AND BALANCE OF PAYMENTS

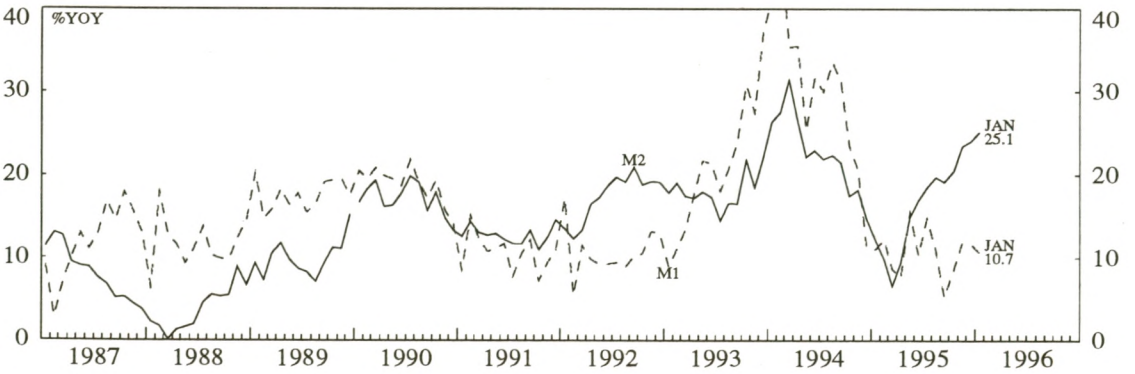


MALAYSIA: MONEY, OUTPUT, GOODS AND ASSET PRICES





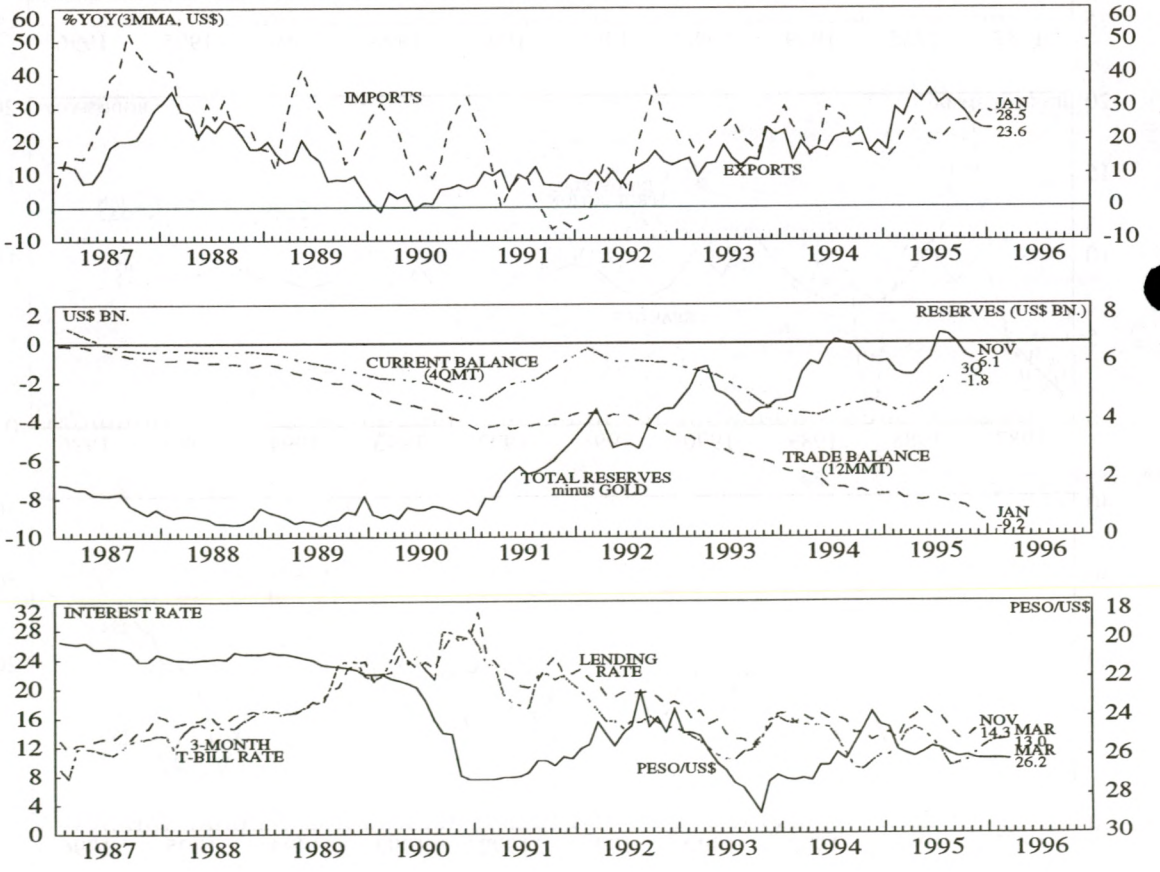




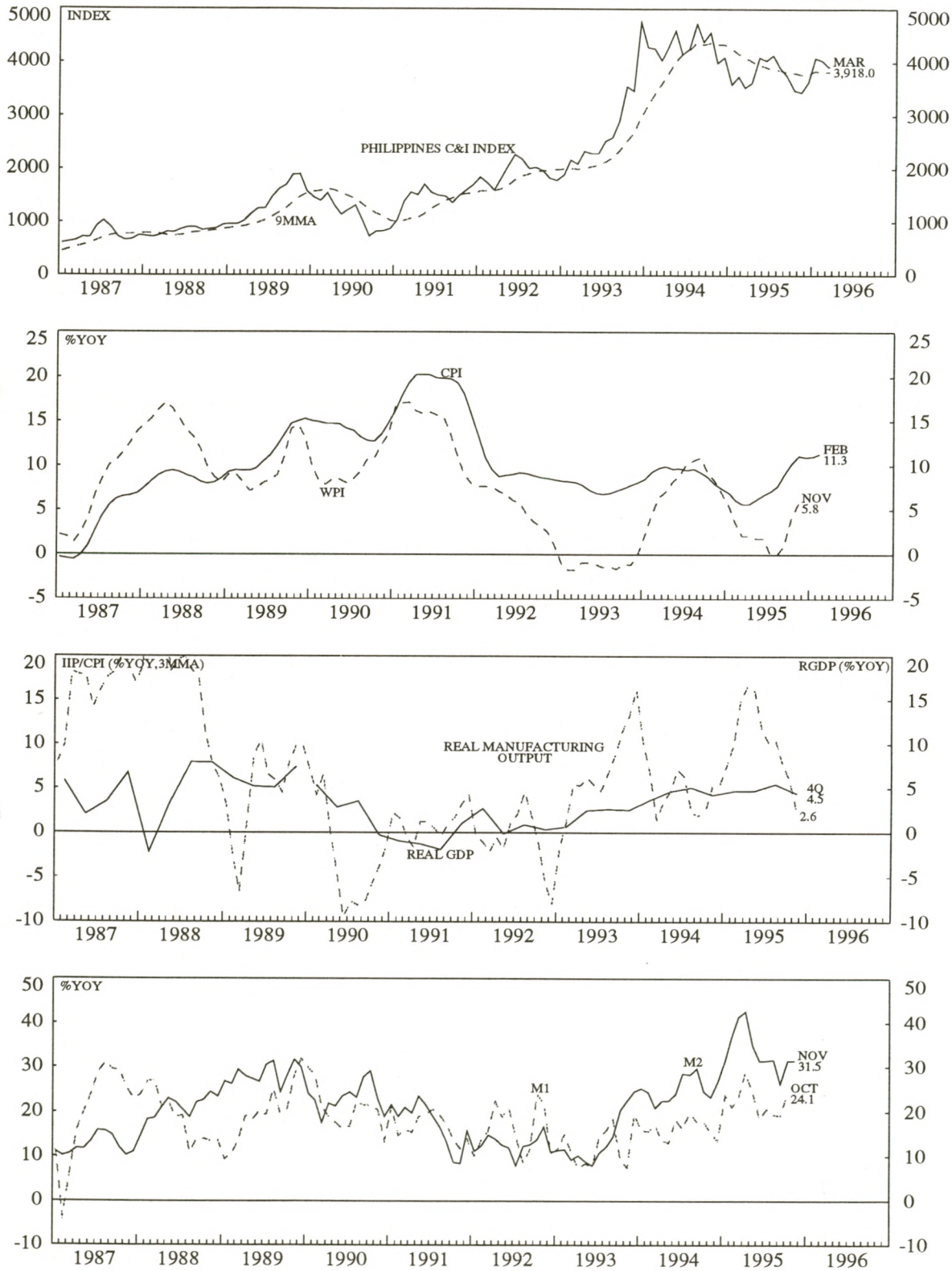
PHILIPPINES: MONETARY EXPANSION CONTINUES

The current expansion in money continues relatively unrestrained even though M2 growth is down from its peak of 42.6 % yoy. The origins of this monetary expansion are: the cuts in reserve requirements from 25% in 1993 to 15% today and, the dramatic rise in capital inflows since 1994. In addition, over the last 12 months competition within the banking system has intensified in response to the entry of new foreign banks. Both the increased competition and lower costs of intermediating credit have lowered interest rates from their high levels in the late 1980s. Credit to consumers and for property purchases continues to grow at a rapid pace raising property prices and rentals. In Metro Manila prime property prices have risen by around 80% since early 1994 and supply still remains tight in both office and residential areas. Real economic growth will remain steady and has room for acceleration as foreign direct investment continues to help develop a manufacturing base. Rapid import growth is a symptom of both strong foreign direct investment and a surge in consumption. Export growth rates in the mid-20s, while impressive, are insufficient to stabilise the trade deficit. However, despite the trade deterioration, large remittances towards the end of 1995 led to an improvement in the current account deficit to 1.3% of GDP. CPI inflation accelerated to 11.3% in February, and will likely remain in double digits and in an upswing through 1996, given the background of monetary expansion.

PHILIPPINES: MONEY MARKET AND BALANCE OF PAYMENTS



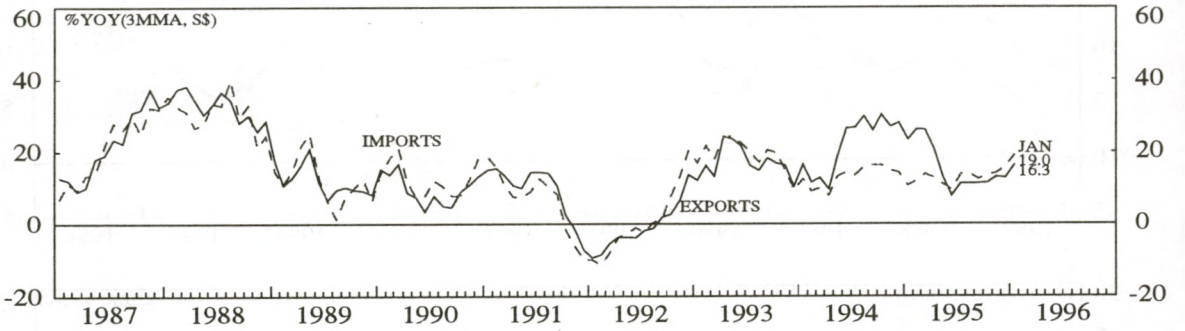
PHILIPPINES: MONEY, OUTPUT, GOODS AND ASSET PRICES

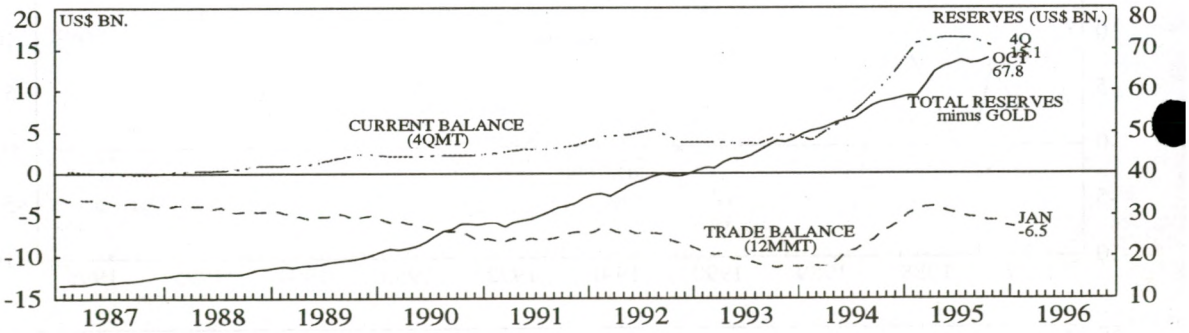


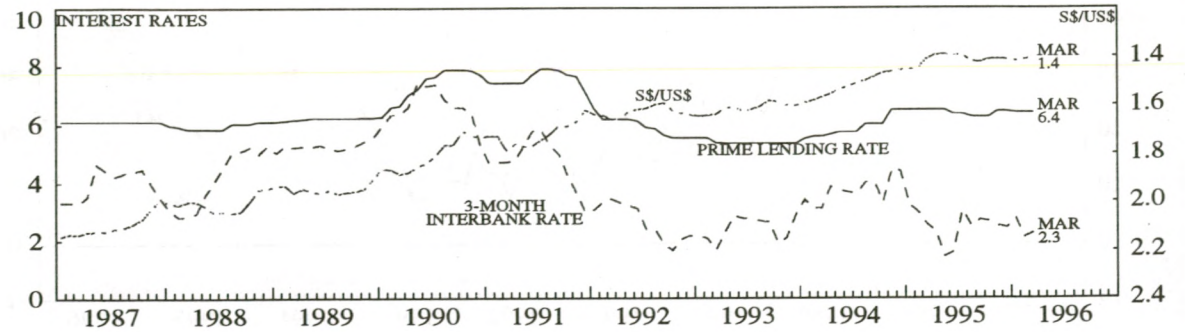
SINGAPORE: TEMPORARY PAUSE IN CURRENCY APPRECIATION

With headline inflation relatively benign, appreciation of the S$ now pauses for breath. Nevertheless, there remains underlying upward pressure on the currency from capital inflows and reserve accumulation, despite a strengthening of the US$. Credit growth has recently picked up, indicating a buoyant real economy, but the main money supply indicators are weak (this could be a result of the government using its sizeable deposits at commercial banks to partly "sterilise" capital inflows). Despite a weak retail sector, lending rates have not been allowed to fall significantly from their peaks in 1994H2. Accelerating import and export growth, primarily in the semiconductor and computer industries respectively, are further indicators of robust economic activity; the trade deficit is gradually widening. Like other Asian economies, export activity should moderate slightly in 1996 alongside slower external demand and perhaps lower demand for semiconductor-related products generally. The services component of the current account, however, remains firmly in surplus.

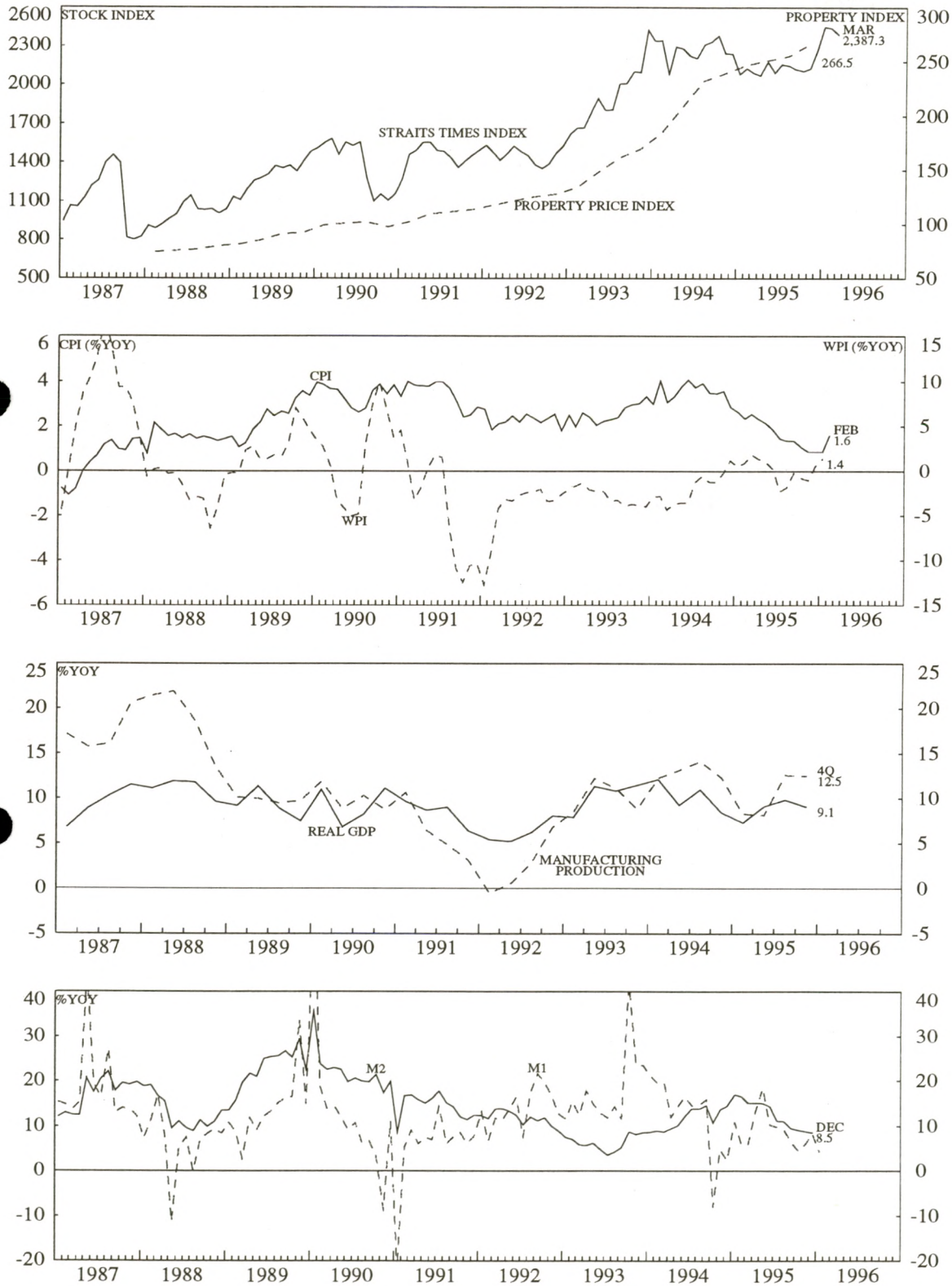
SINGAPORE: MONEY MARKET & BALANCE OF PAYMENTS







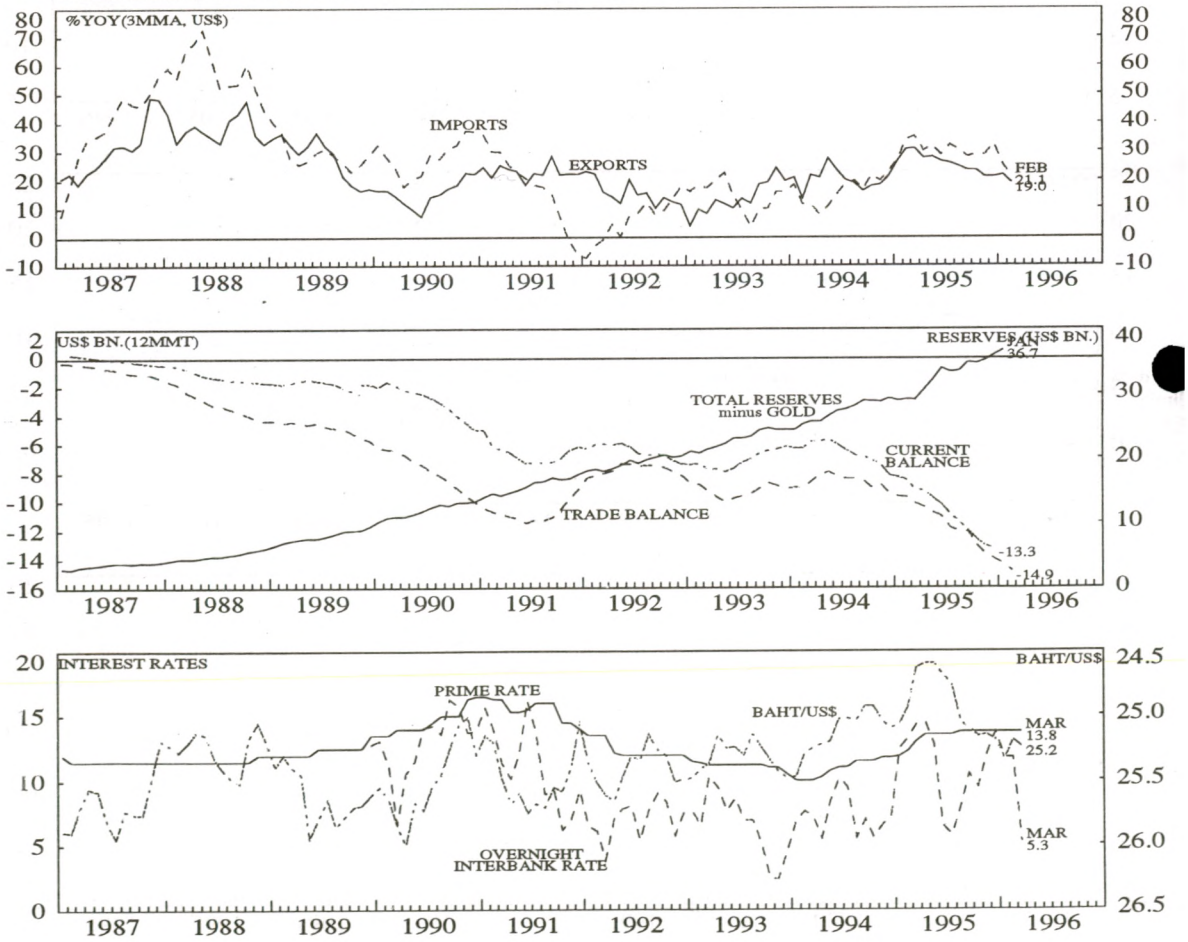
SINGAPORE: MONEY, OUTPUT, GOODS & ASSET PRICES



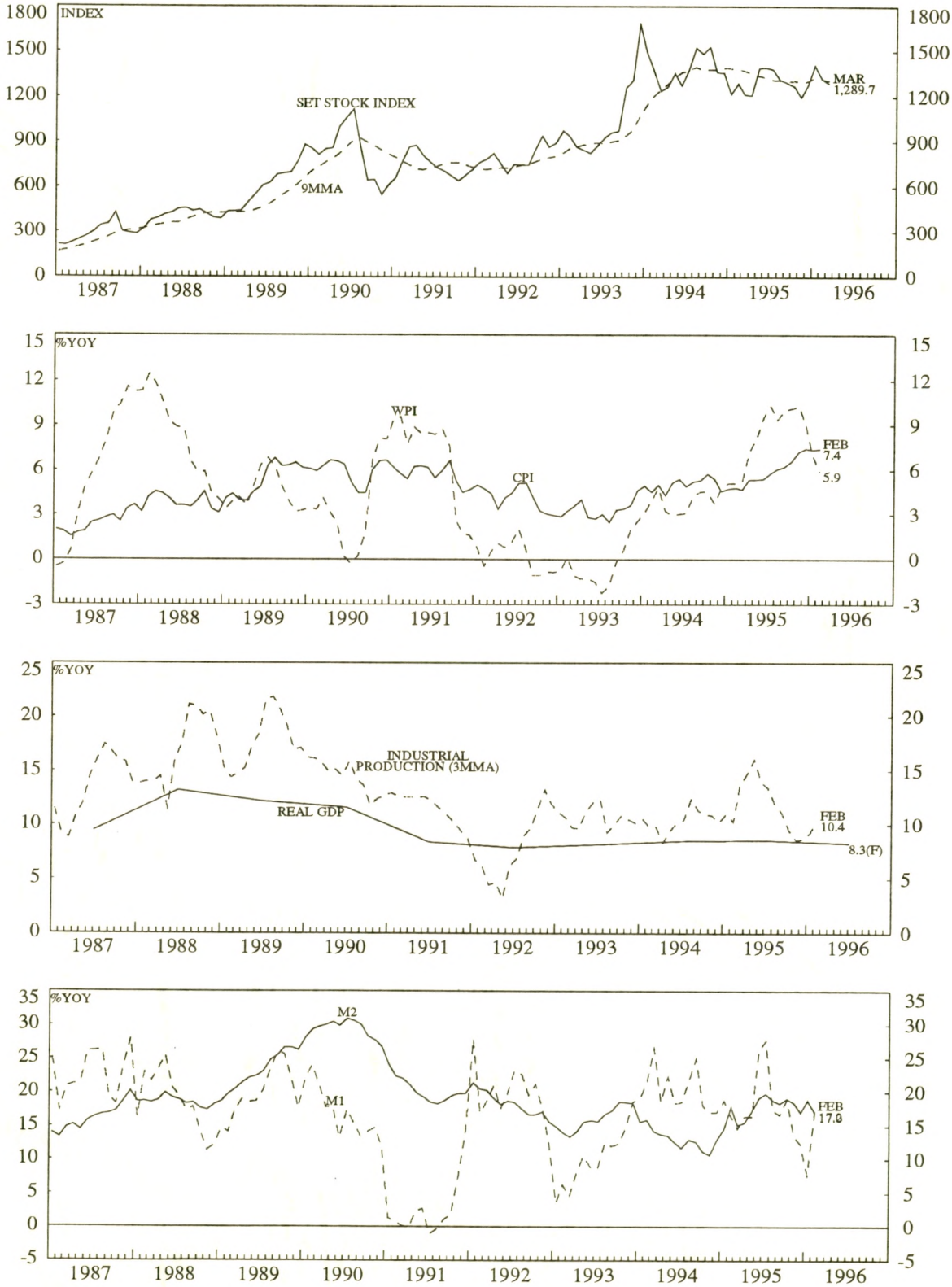
THAILAND: CURRENT ACCOUNT DEFICIT STILL A LINGERING WORRY

Industrial production remains relatively subdued although across other sectors of the economy the signs of any substantial slowdown are less obvious. The two mains symptoms of overheating, rising inflation and a widening current account deficit, continue to represent major challenges for policy makers. Both problems are the direct result of excessive credit growth in the past two years, although the recent in acceleration inflation is partly reflecting food shortages following last years flood damage . Total loan growth continues to decelerate gradually, in response to a number of measures taken by the Bank of Thailand (BoT) in 1995 to restrict the inflow of foreign capital. However, decelerating credit growth has yet to feed through decisively into lower M2 growth. Volatile short-term deposit rates have often been driven to very low levels by capital inflows, which in turn have tended to anticipate the downward movement of US interest rates in the year ahead. On the other hand, prime lending rates have remained high as the BoT attempts to remain "decoupled" from any easing of US monetary policy for as long as possible. With apparently only modest success so far in cooling domestic demand, the BoT can be expected to announce further, but only mild, monetary tightening in 1996. Despite the apparent problems in reining in economic activity, one obvious indication of tight monetary conditions has been the stock market, which has underperformed most markets in the region during 1996Q1.

THAILAND: MONEY MARKET AND BALANCE OF PAYMENTS



THAILAND: MONEY, OUTPUT, GOODS & ASSET PRICES



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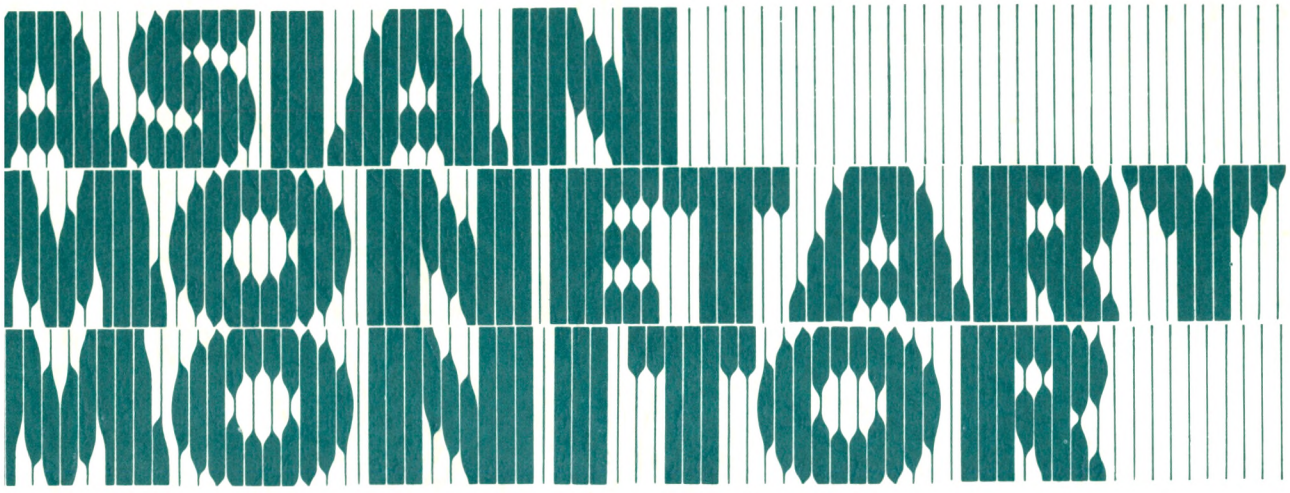

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ASIAN MONETARY MONITOR

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JAPAN
TRADE ADJUSTMENT ACCELERATES, DEFLATION BROADENS

Japan's economy has finally embarked on recovery. However we believe the present recovery will be significantly different from any previous recovery in Japan's post-war history in almost all aspects. The present recovery will be slower than previous recoveries, as the economy's sustainable growth rate is lower and the traditional sources of growth are less potent. The present recovery will therefore be led by domestic demand (mainly consumption) rather than net exports. Indeed, the present recovery will continue to see significantly negative contributions from net exports as Japan's pattern of trade (and its previously stubbornly high trade surplus) continues to adjust. Finally, the present recovery in real activity will continue to be accompanied by deflation (especially of domestic prices) for a while longer. Our assessment of Japan's present economic recovery[1], in particular the assertion that trade adjustment and deflation will continue well into 1997, is by no means uncontroversial and requires further explanation.

High Price Level Necessitates Adjustment

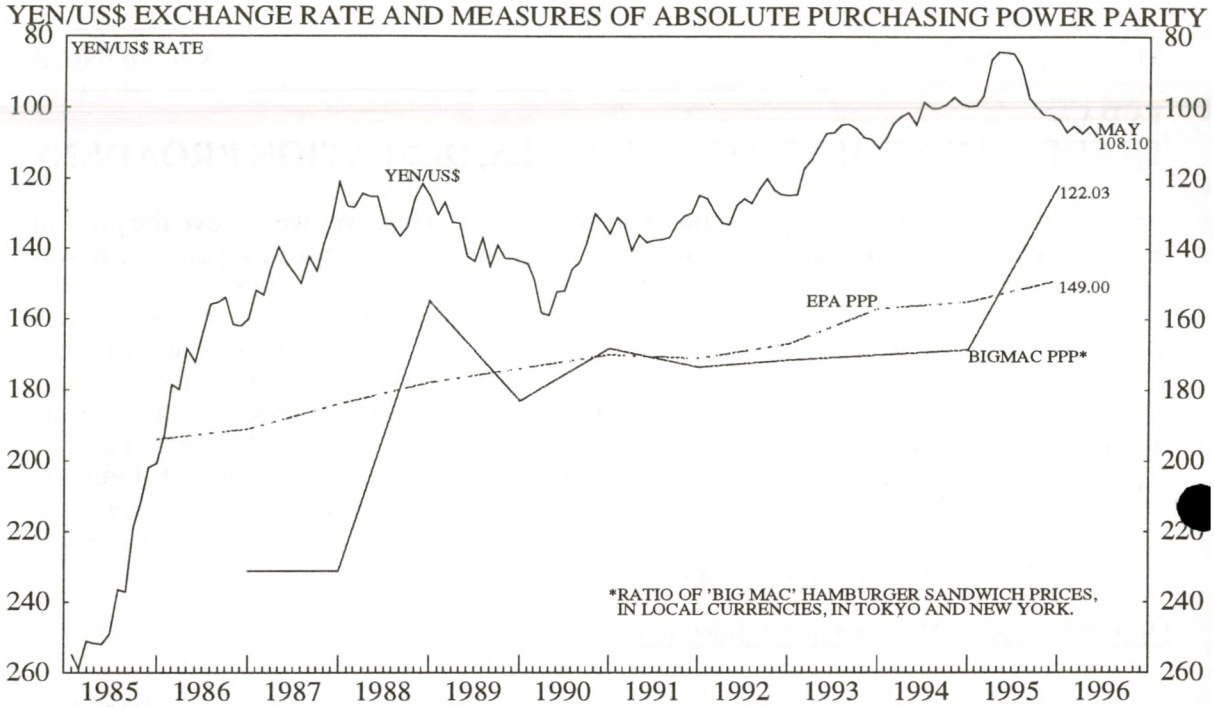
A major obstacle to recovery has been (and remains) the high level of prices and costs in Japan compared to the rest of the world. This origin of this obstacle can be attributed both to inefficiencies in Japan's domestic economy, particularly in the distribution system, and also to distortions in Japan's balance of payments. A year ago this obstacle (of Japan's high relative level of prices and costs) was exacerbated by rapid and excessive appreciation of the yen, a factor which has now been partially unwound as the yen has reversed to the level where it was in the first half of 1994. However, even at the current exchange rate (of around 108) the levels of prices and costs in Japan are still significantly above world levels.

Most calculations of purchasing power parity (PPP) use national consumer or wholesale price indices, assuming a fair value for the exchange rate prevailing in a particular year or on average over a long time period. One problem with this methodology is that the price index baskets are not necessarily comparing like with like. Some analysts even use manufactured goods export prices, but purchasing power parity for internationally traded goods is (transport costs and quality differences aside) something of a tautology. Ideally, the PPP parity calculations should be made comparing the prices of the exact same basket of goods and services across countries. Fortunately such comparisons do exist. Surveys by various management consultant of the cost of doing business in various cities around the world still rank Tokyo at or close to the top. Chart 1 shows the yen/dollar exchange rate and two other absolute measures of purchasing power parity, Japan's Economic Planning Agency's international price survey (covering a wide basket of goods and services in Tokyo and New York), and the Economist Magazine's survey of the prices of a 'Big Mac' hamburger sandwich (local produce to common international standard). Both these measures of PPP for the yen/dollar rate are significantly weaker than the current actual exchange rate, indicating that costs in Japan are still significantly above costs elsewhere in the world.

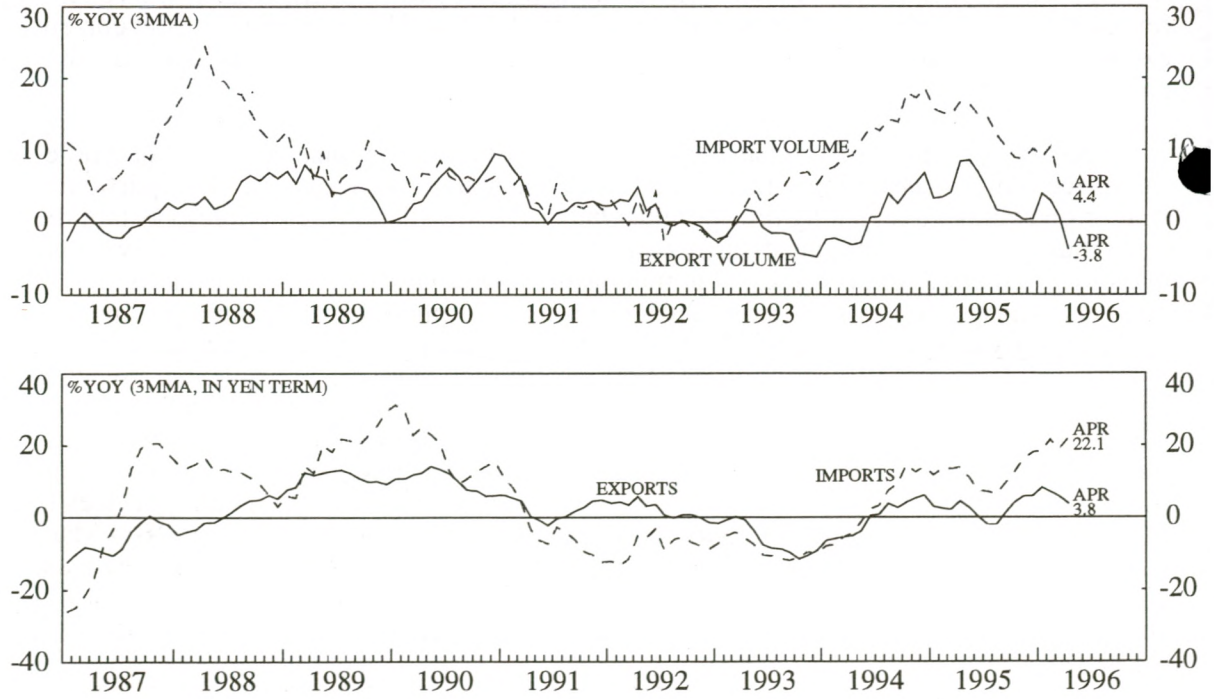
---

[1] See "Japan: A Deflationary Recovery" in AMM March-April 1994 and "Japan: A Consumption-led Deflationary Recovery" in AMM Sept.-Oct. 1994.

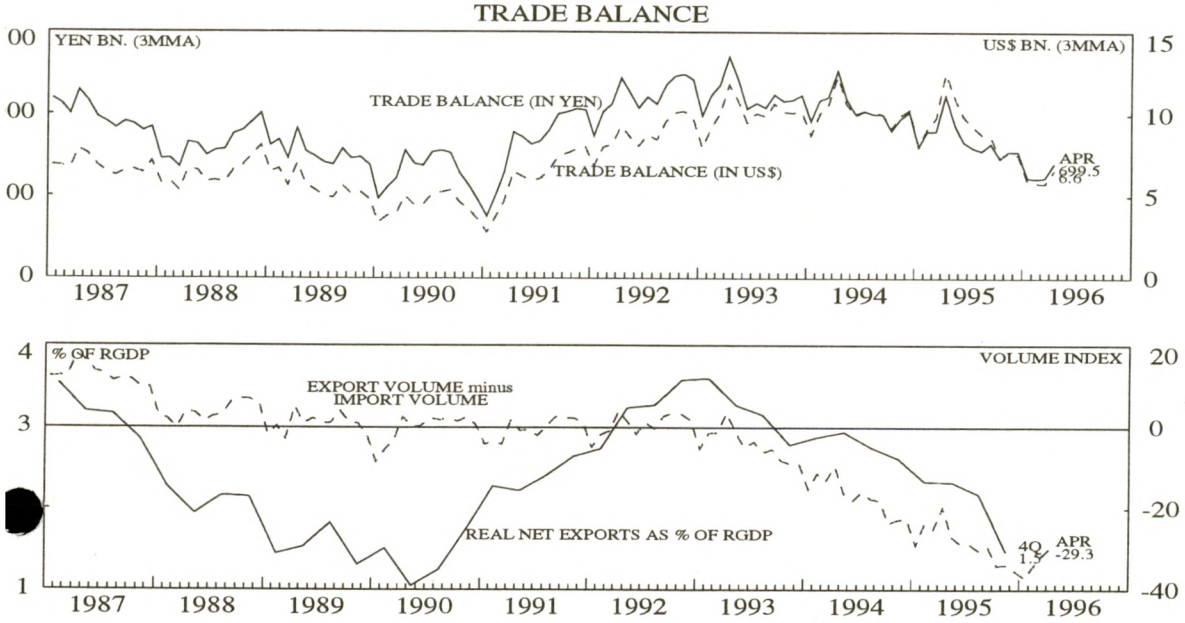
JAPAN: CHART 1
YEN/US$ EXCHANGE RATE AND MEASURES OF ABSOLUTE PURCHASING POWER PARITY



JAPAN: CHART 2
EXPORTS AND IMPORTS GROWTH



JAPAN: CHART 3
TRADE BALANCE



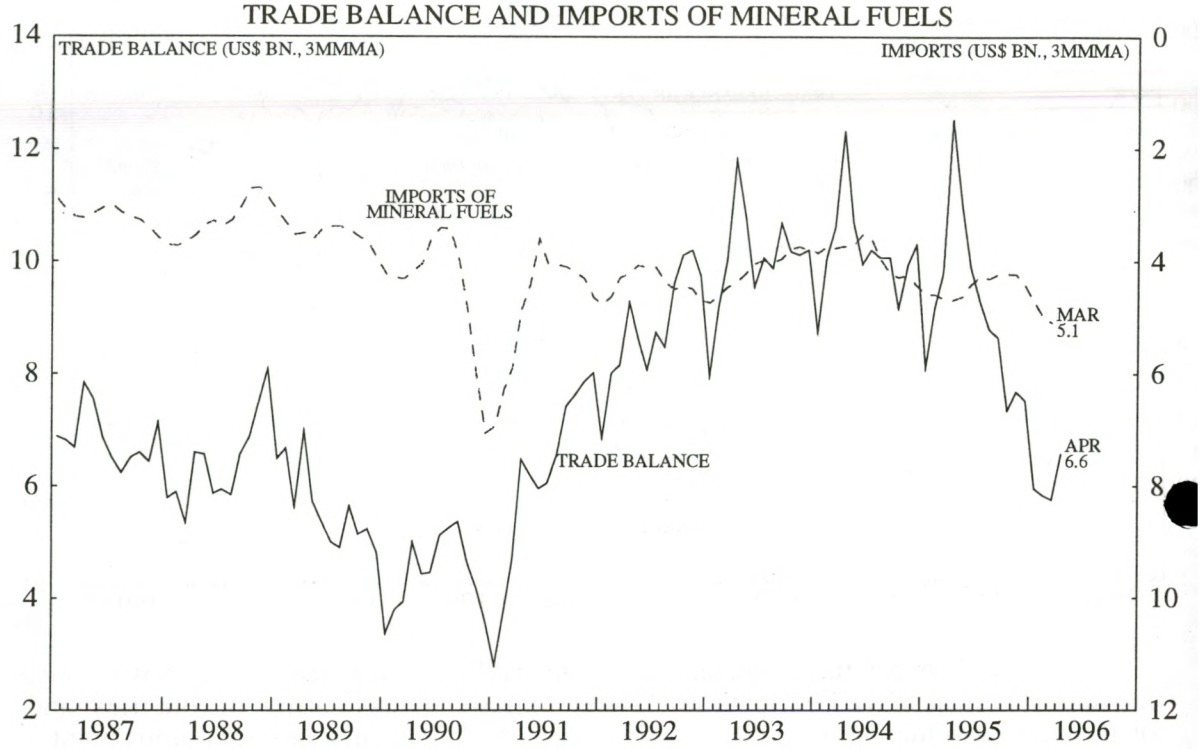
The gap between the actual exchange rate and PPP 'fair value' can narrow through movements either in the PPP rate (i.e. different inflation rates in different countries) and/or through movements in the actual exchange rate. In Japan's case this adjustment is being effected through both routes, as implied by the lines in Chart 1. The actual exchange rate is weakening because Japan's trade and current account surpluses are narrowing rapidly due to lack of competitiveness and still weak external demand. PPP fair value is moving closer to the actual exchange rate as prices elsewhere (e.g. in the USA) continue to rise (albeit at a modest pace) and prices in Japan continue to deflate under the twin pressures of increased import penetration and weak nominal domestic demand. Last year's rapid move in the 'Big Mac' PPP rate was due to a 25% cut in the price of a 'Big Mac' in Japan, a typical (if somewhat extreme) example of price deflation (popularly known as 'price destruction') in Japan. We now consider in turn the adjustments on Japan's trade balance and on Japan's domestic prices.

Trade Adjustment Accelerates

Japan's trade and current account surpluses are declining rapidly. Although in US dollar terms this has only been evident since the middle of last year, the trend has been evident much longer in terms of yen-based value, volume and in terms of real GDP accounts. Indeed, as the Japanese government has now ceased to publish its trade figures in US dollar terms, it has become more usual to focus on yen-based balance of payments accounts.

The growth rate of imports started outpacing that of exports in early 1993 in volume terms and in mid-1994 in nominal value (e.g. yen) terms, as shown in chart 2. However, given the scale difference between imports and exports, it took until about the middle of 1995 before the declining trade surplus (in both yen and US$ terms) became a generally accepted reality. But in term of differences of export volumes and in terms of real GDP accounts the decline of Japan's trade surplus has been clearly evident since early 1993, as shown in Chart 3.

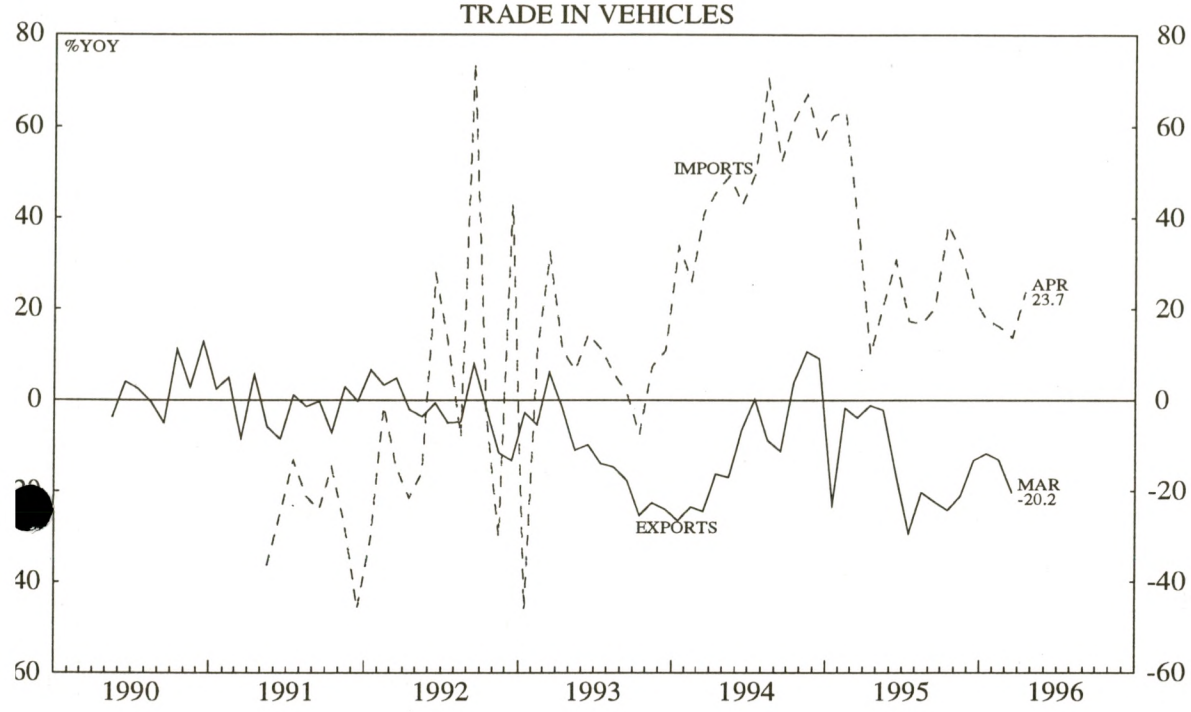
JAPAN: CHART 4
TRADE BALANCE AND IMPORTS OF MINERAL FUELS



In value terms, Japan's trade surplus seemed stubbornly high until the middle of 1995, as Japan benefited from reduced unit price of imports of raw materials and mineral fuels. Indeed, much of the fluctuations in Japan's trade surplus can be explained simply in terms of the cost of its imports of mineral fuels, as shown in chart 4. Japan's trade balance also benefited for some time from strong pricing power by Japanese exporters of certain types of machinery (e.g. semiconductor manufacturing equipment) who were able to raise their export prices in dollar terms to compensate to a significant extent for the fall in the yen value of their dollar receipts. Finally the rise of the yen until the second quarter of 1995 meant that a trade surplus which was falling in yen terms continued to rise in US dollar terms. In other words, the rise in Japan' trade surplus was due to 'favourable' (but eventually uncompetitive) changes in Japan's terms of trade (import prices, export prices and the exchange rate) and not to any trends in trade volumes.

Structural change in Japan's trading pattern is particularly evident in the sectors where Japan has traditionally had a dominant international market position. Chart 5 shows that Japan's vehicle exports have only registered intermittent months of positive growth this decade, and have been registering negative growth every month since January 1995. Japan's vehicle imports, on the other hand, have been growing at double-digit rates since early 1994. This change is in large part due to Japanese car manufacturers relocating their production facilities outside Japan, both to escape the high costs of land and labour in Japan, and sometimes to circumvent barriers to trade. The adjustment still has some way to go, although imported vehicles now account for almost 10% of car sales, up from only 3% in 1991.

JAPAN: CHART 5
TRADE IN VEHICLES



JAPAN: CHART 6
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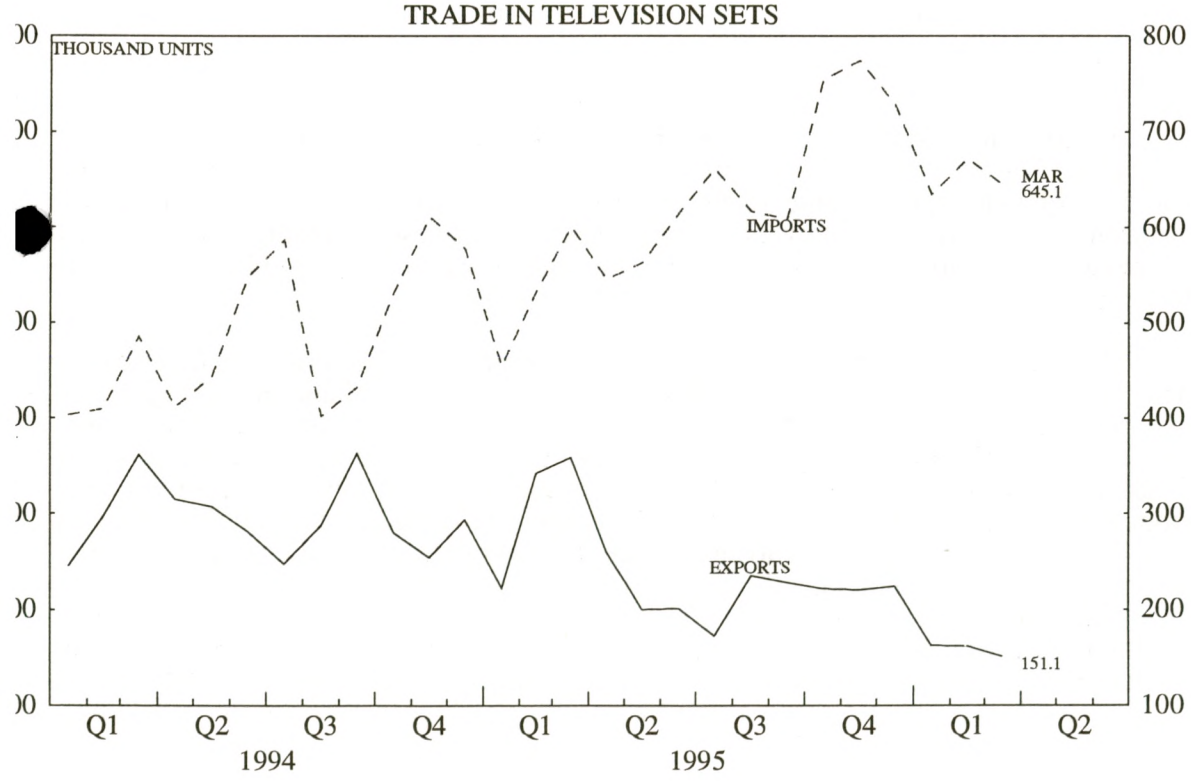
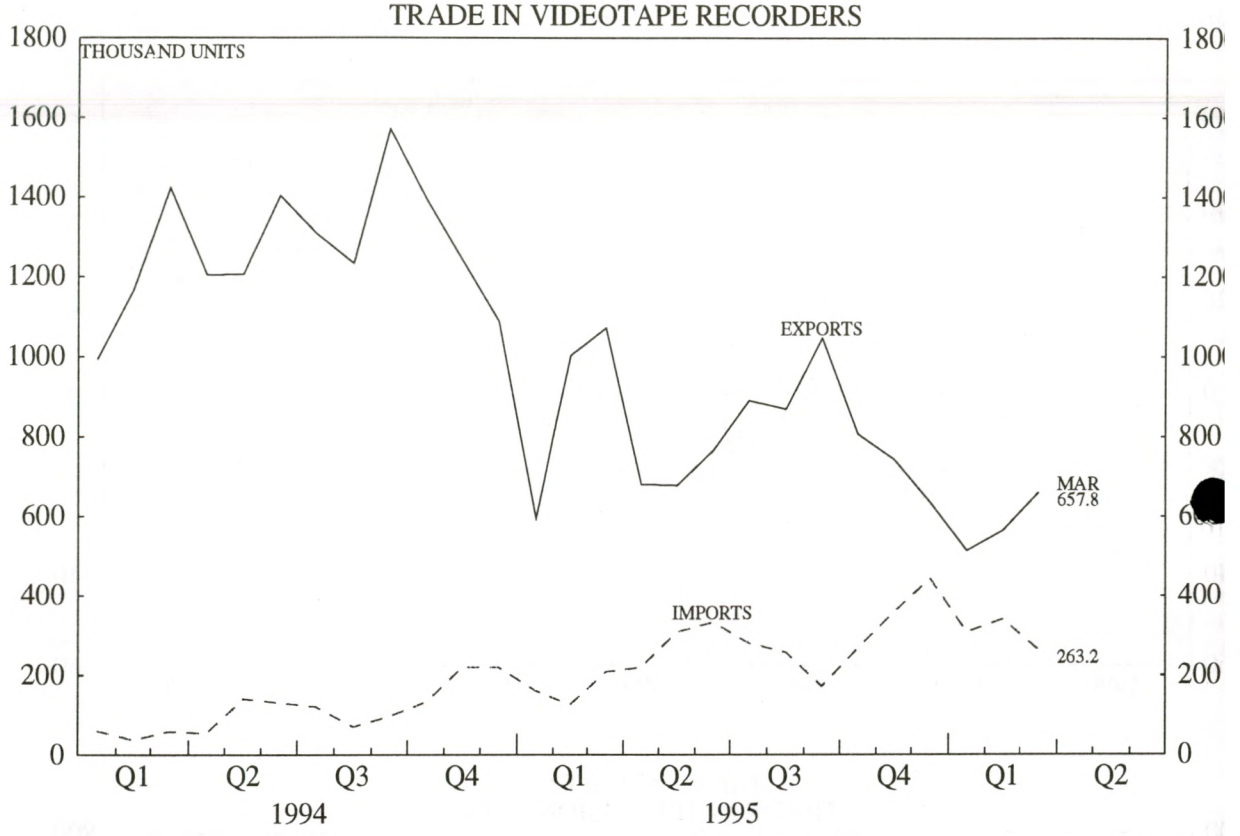


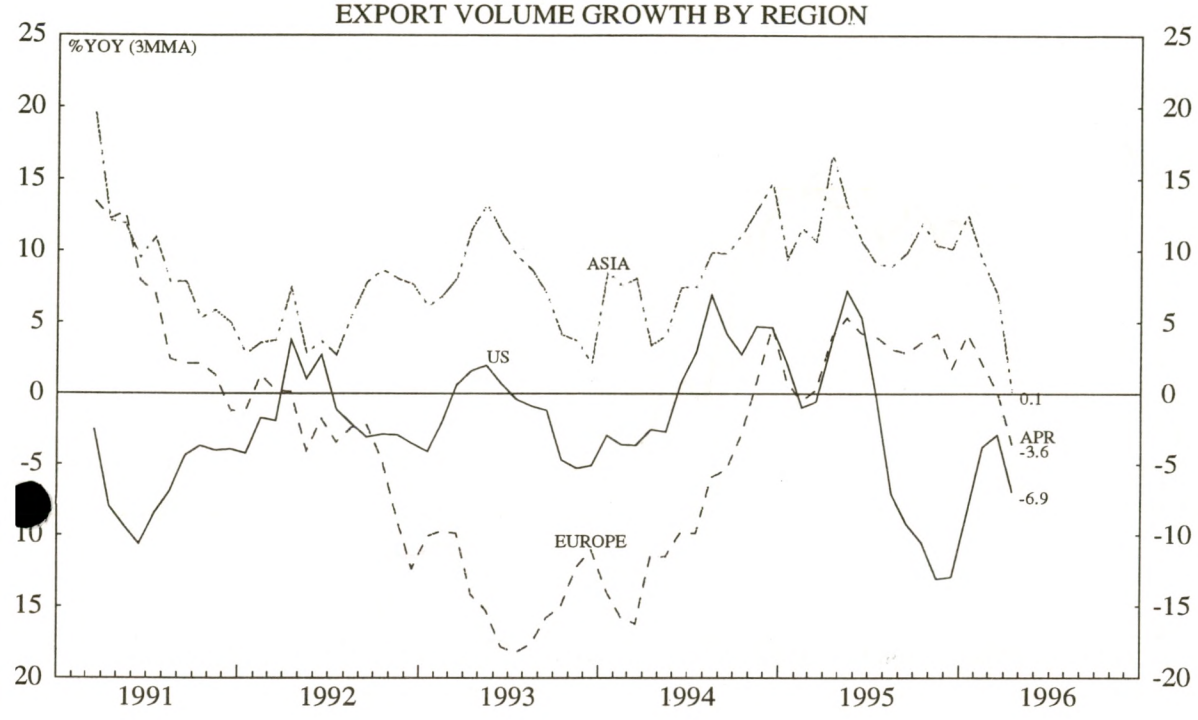
JAPAN: CHART 7
TRADE IN VIDEOTAPE RECORDERS



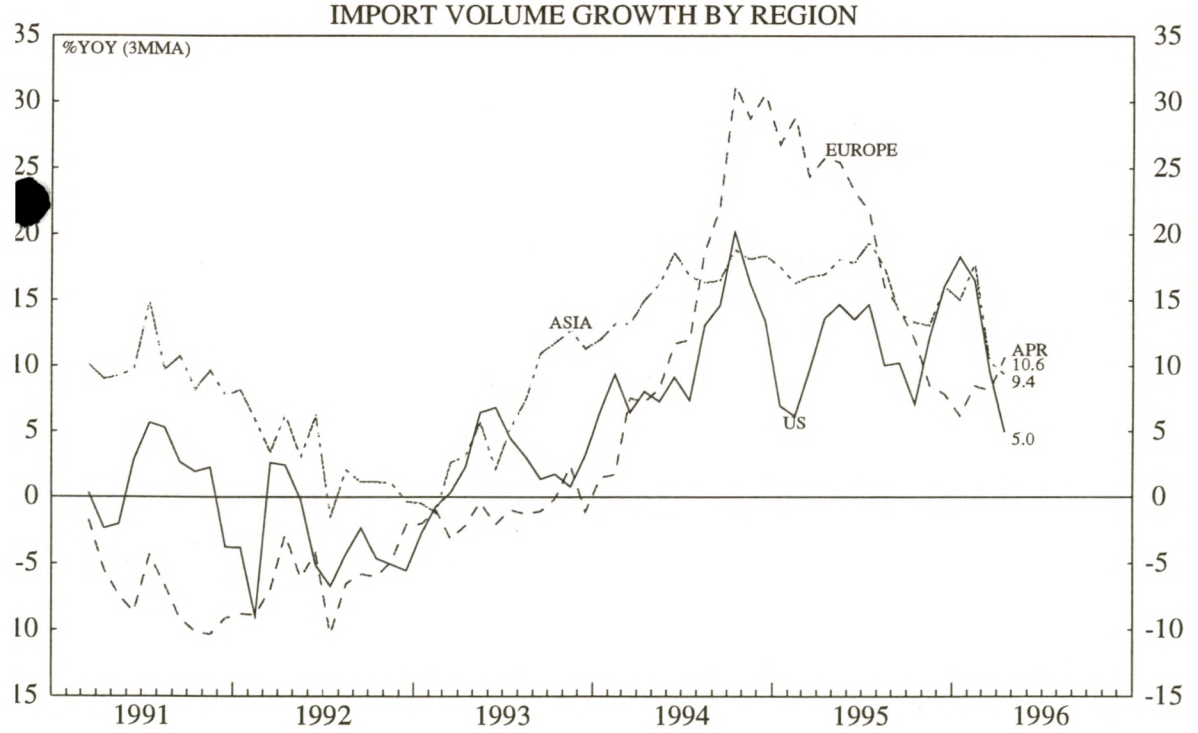
Charts 6 and 7 show the same trend for Japan's trade in television sets and videotape recorders. For the 12 months to March 1996, imports accounted for 80% of televisions and 57% of video-tape recorders sold in Japan. Admittedly, many of these consumer electronics were produced at overseas subsidiaries of Japanese companies; but this does not negate the negative impact this trend has for Japan's trade balance and level of domestic economic activity.

The structural changes behind Japan's deteriorating trade performance are also evident on a geographical basis. Chart 8 shows Japan's export volume growth by major export markets, with exports to both the USA, the EU and Asia shrinking in volume terms, suggesting either Japanese exports are uncompetitive and/or that import demand is still weak in these economies. Chart 9 shows the strong growth in Japan's import volumes from the same areas. Given the continued weakness of domestic demand this suggests that Japanese products are even losing competitiveness in the domestic market. We expect that this adjustment in Japan's trade balance in volume terms will continue for as long as Japan's exchange rate is sufficiently uncompetitive to attract increased import penetration and a loss of market share internationally. In value terms much will depend on the trend of prices elsewhere, but it would seem likely that any increase in the export price of cyclical goods would be offset to a significant extent by higher prices of imported commodities.

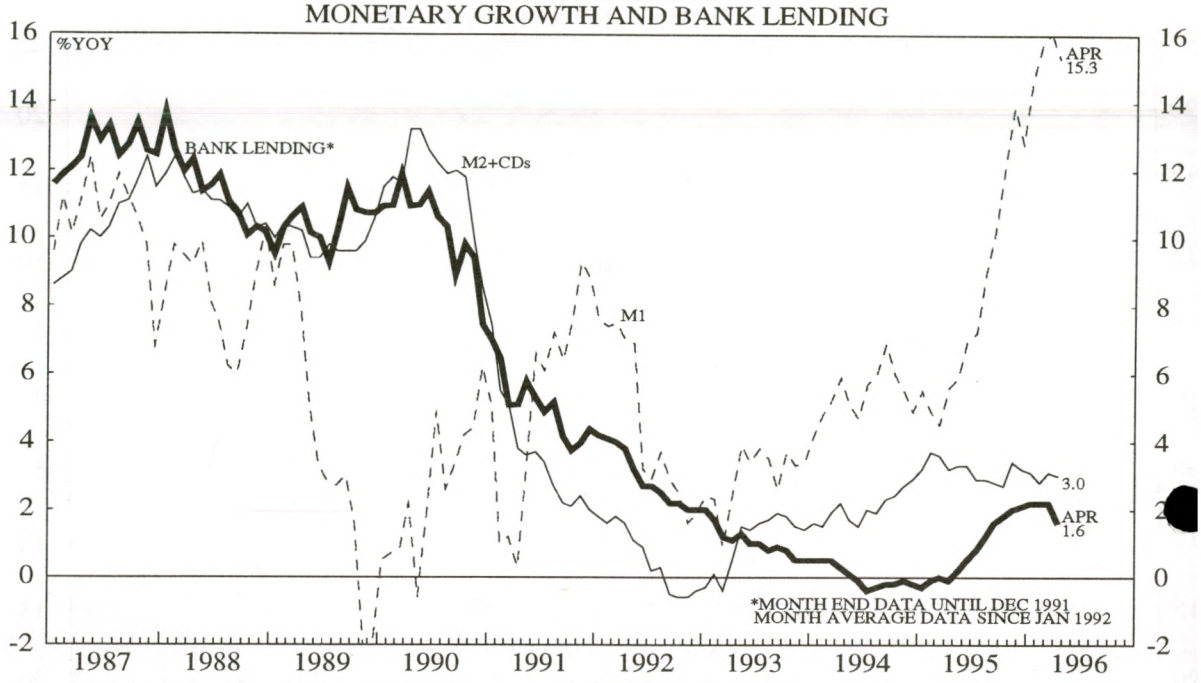
JAPAN: CHART 8
EXPORT VOLUME GROWTH BY REGION



JAPAN: CHART 9
IMPORT VOLUME GROWTH BY REGION



JAPAN: CHART 10
MONETARY GROWTH AND BANK LENDING



Deflation Broadens

The main reason for Japan's slow nominal growth rate has been inadequate growth of money and credit. Chart 10 shows the growth rate of the most reliable monetary indicator in Japan, M2+CDs along with two other indicators which have been used (in our view misleadingly) to support arguments for a much stronger economic recovery, narrow money (M1) and bank lending.

As we have argued before[2] M1 has been distorted by the virtual disappearance of any interest rate differential between quasi-money (assets inside M2+CDs but outside M1, such as time deposits, savings deposits and CDs) on the one hand and M1 assets (cash currency and demand deposits) on the other. Without any interest rate incentive or any need to hedge against inflation in the near future, maturing time deposits have simply not been renewed but have lapsed into M1 type assets. It is worth bearing in mind that on average over the past 5 years, M1 has only been equivalent to 27.1% of GDP, while M2+CDs have been equivalent to 1.09 times the size of GDP. This means that the recent 15.3% growth in M1 was only equivalent to a +1.1% contribution to growth in M2+CDs, which was partially offset by a -1.5% decline in quasi-money making a 4.1% contribution to growth in M2+CDs. Some observers point to the rapid growth of US M1 in the early 1990s as an argument for focusing on M1 as a leading indicator of demand, but fail to mention more recent negative growth of US M1 and the structural changes that have occurred within the US banking system throughout the past 10 years (growth of mutual funds, sweep accounts, etc.).

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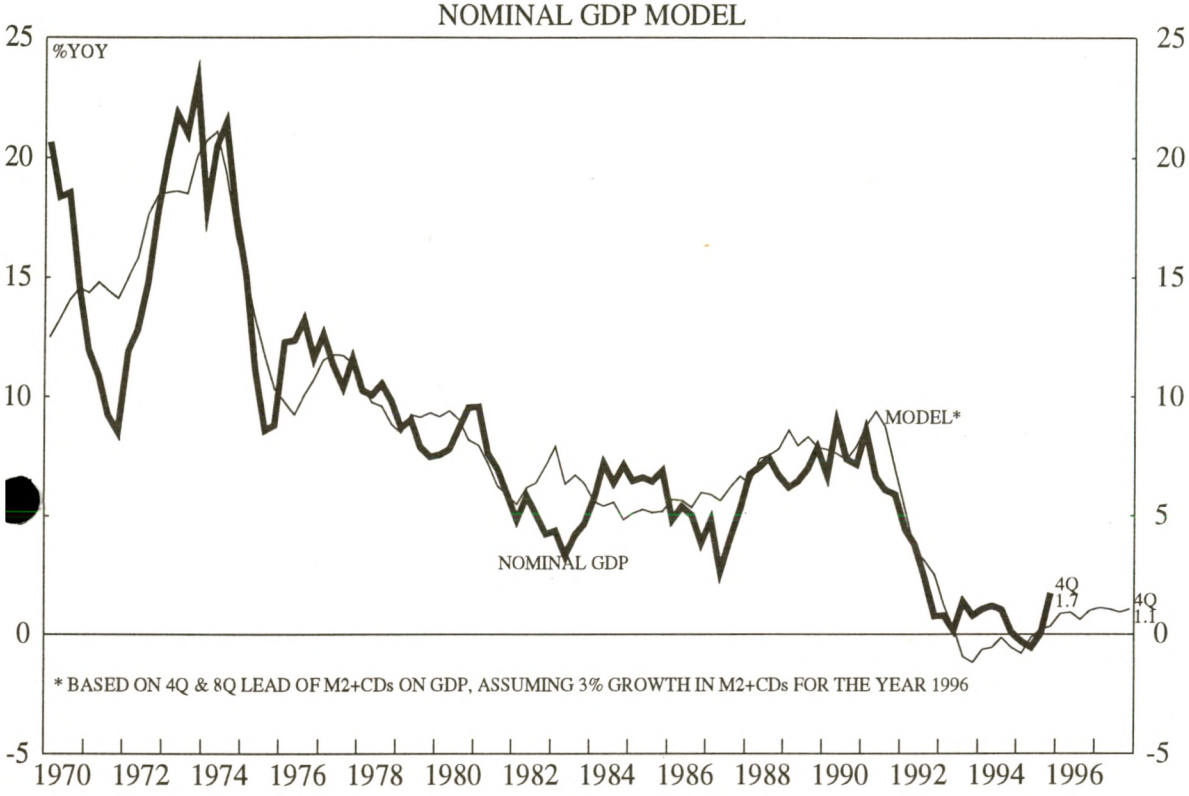
[2] See "Japan: Rising Liquidity Preference of Money Demand" in AMM Nov-Dec. 1995 and "Japan: Leakages Weaken Money and Credit Multipliers" in AMM Jan.-Feb. 1996.

JAPAN: CHART 11
NOMINAL GDP MODEL



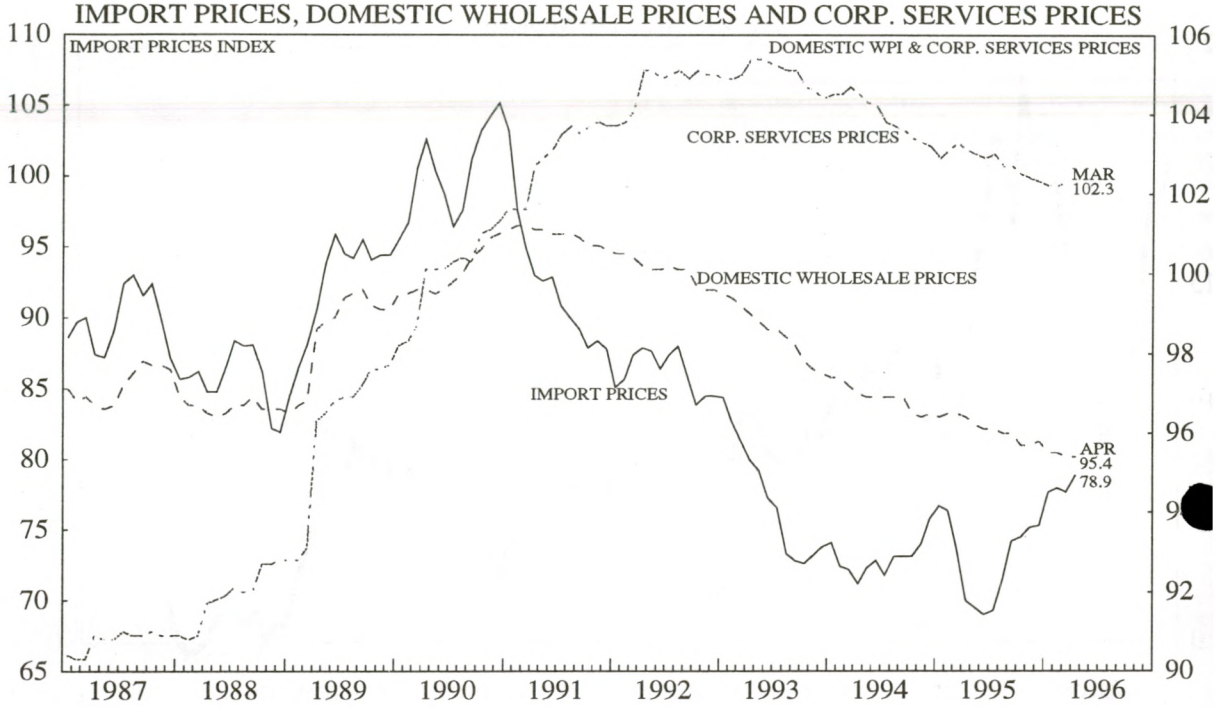
The modest recovery in bank lending since the middle of 1995 has been largely concentrated in housing finance, and largely offset cessation of growth in loans by the government's Housing Loan Corporation. Adding together loans by both banks and government financial institutions, we find that total loan growth is still on a decelerating trend.

M2+CDs is the monetary aggregate which has the closest correlation with nominal GDP growth, and as our model in Chart 11 shows recent growth in M2+CDs is only supportive of modest nominal GDP growth of around 1% in 1996 and 1997. However, with continued downward pressures on prices in Japan (from increased domestic competition and increased diffusion of imports) 1% nominal GDP growth will probably translate into around 2% real GDP growth.

The downward pressures on prices in Japan have broadened significantly, as shown in Charts 12 and 13. Import wholesale prices (in yen terms) peaked in 1990 and fell by one third by the middle of 1995, and although they have risen by 15% since the trough (due to the weakening of the yen), they are still significantly below Japanese price levels and continue to exert downward pressure on domestic prices. Domestic wholesale prices peaked around the same time, but have only come down by 7% since then. Finally, the corporate survey price index peaked only in 1993. Given that Tokyo is still regarded by several management consultants as the most expensive city in the world for business, there would seem plenty of scope for the corporate service price index to decline further.

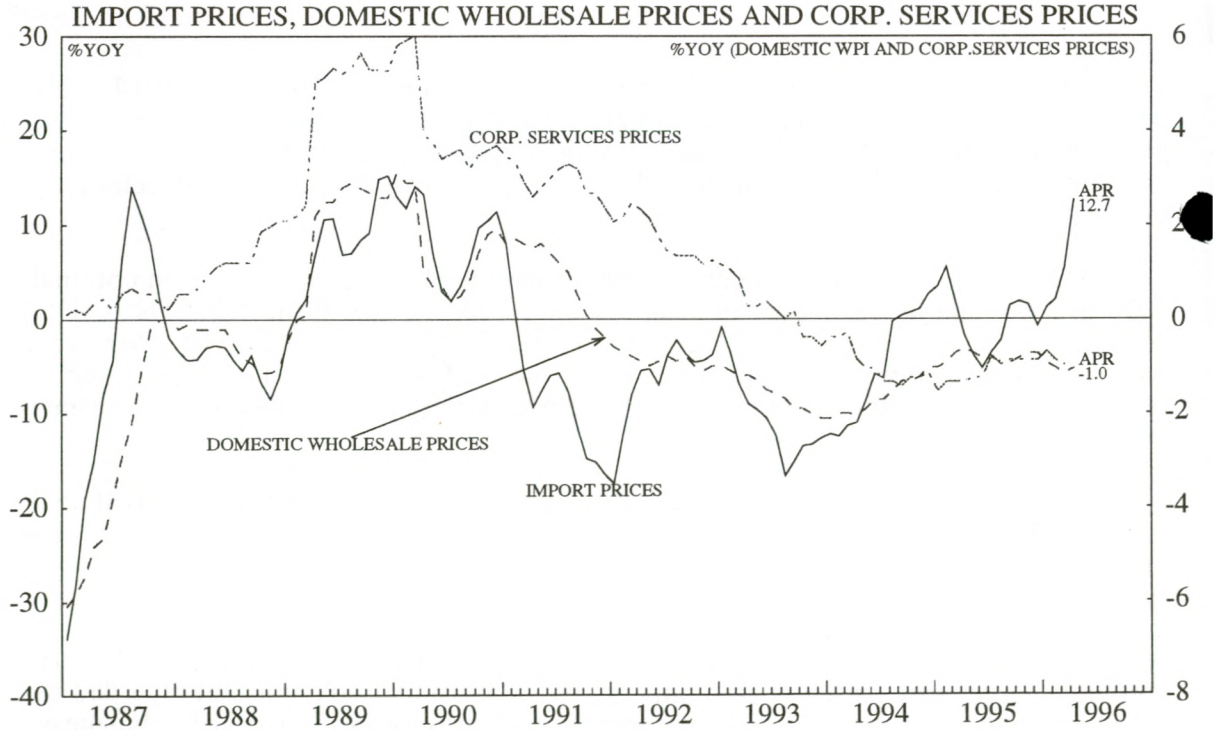
JAPAN: CHART 12

IMPORT PRICES, DOMESTIC WHOLESALE PRICES AND CORP. SERVICES PRICES

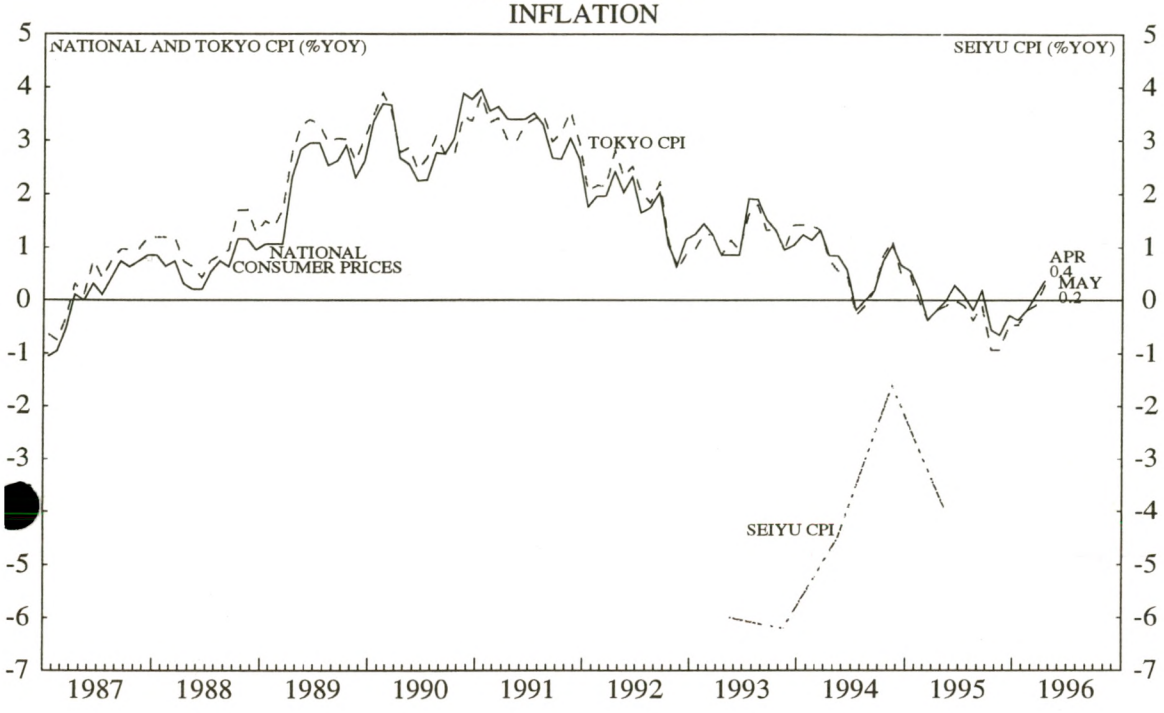


JAPAN: CHART 13

IMPORT PRICES, DOMESTIC WHOLESALE PRICES AND CORP. SERVICES PRICES



JAPAN: CHART 14
INFLATION



Although the most recent months of CPI figures have shown fractionally positive price increases (see chart 14), the CPI will probably register negative rates of change over the next 12 months. There are, in our view, several distortions to the CPI. Firstly, the sample bias is towards traditional retailers which have not cut prices as aggressively as more dynamic newcomers. The Seiyu Price Index, which covers the prices of all goods available in the Seiyu group supermarkets, has been deflating since its inception. Secondly, the CPI fails to capture rapid change in the quality of some consumer durables. For example, while the automobile CPI rose 0.6% annually between 1990-94, a quality-adjusted price index fell by just 0.3% annually, according to research at the Bank of Japan's Institute for Monetary and Economic Studies[3].

The recent positive numbers of the CPI have also been affected by the unusually strong impact of the 12.7% rise in import prices offsetting what is still falling prices for many domestic products. Indeed, as shown in chart 15, the private consumption deflator (which is broader and more representative than the CPI, and nets out the direct impact of import prices) has been deflating for the whole of 1995, and falling more rapidly than the GDP deflator since the 3rd quarter of 1995. The path of import prices and their impact on other price indices will obviously depend on the future path of the yen. With a base case scenario of only gradual 5%-10% annual depreciation of the yen from here on in, the impact of rising import prices will not be enough to offset continued deflationary and disinflationary pressures on domestic prices.

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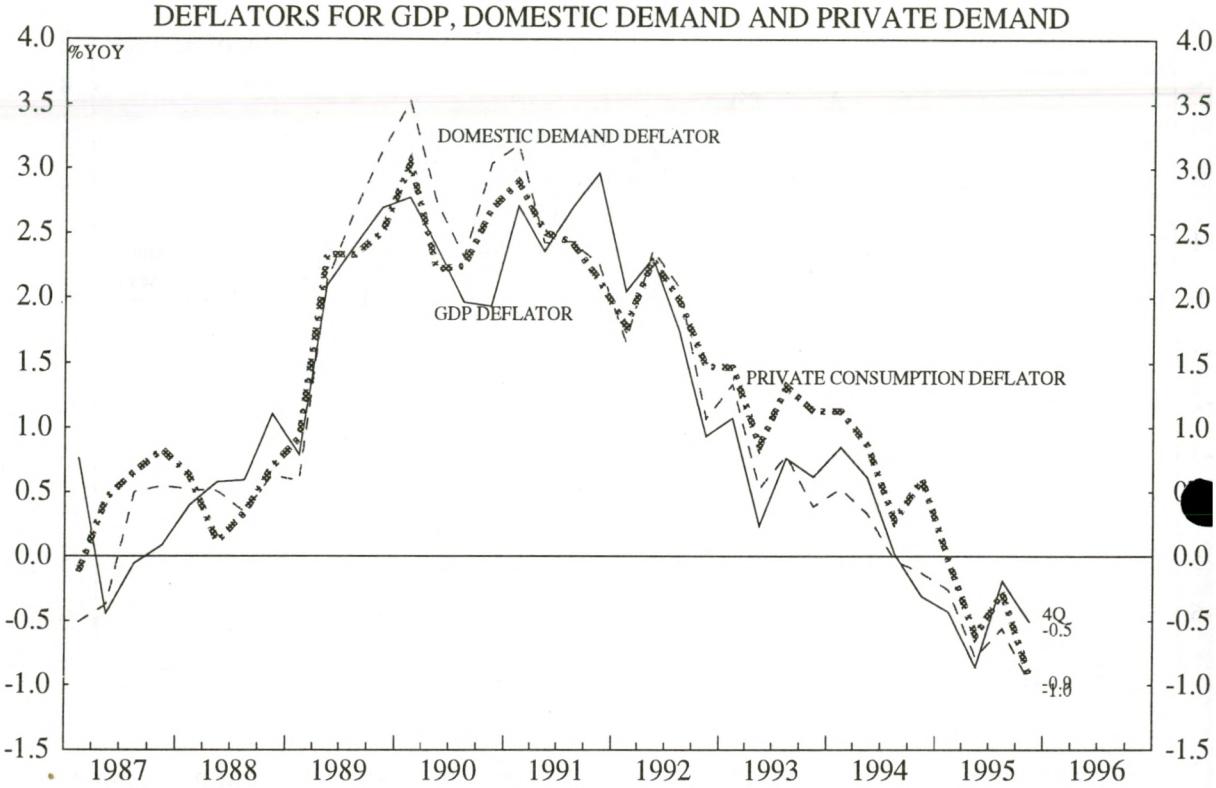
JAPAN: CHART 15
DEFLATORS FOR GDP, DOMESTIC DEMAND AND PRIVATE DEMAND



SUMMARY & CONCLUSIONS: Japan's economic recovery will be accompanied by deflation and trade adjustment for some time to come. Given the continued balance-sheet adjustment in the financial sector, broad money and credit aggregates cannot be expected to accelerate significantly, unless there is further easing of monetary policy. Current growth rates of M2+CDs are only supportive of modest nominal GDP growth of around 1% for 1996-97, although continued deflation can translate this into real GDP growth of around 2%. Continued deflation of domestic prices and the absence of inflationary pressures overall will also mean that there will be no need to raise interest rates, especially not while the cash flow of some financial institutions remains dependent on low short-term interest rates. Continued trade adjustment will result in further weakening of the yen by an estimated 5-10% annually from here on in. Continued deflation will erode gross margins and profitability for many domestically oriented companies. However, those companies which manage successfully to restructure and take advantage of the opportunities afforded by deregulation, will at times present interesting investment opportunities. Although continued deflation will be positive for bonds, a weakening yen and a more open capital account may make Japanese yields (on both bonds and equities) less immune to comparison with and influence from yields in other countries.

SINGAPORE
STRONGER CURRENCY OR STRONGER ASSET PRICES

Introduction

Over the last couple of years, rapid economic growth in Singapore has been supported by two main factors: further expansion and development in the semi-conductor industry and further growth in the services industry. Both of these sources of growth rely to a degree on foreign investment which, in turn has placed upward pressure on the currency. In 1994, the authorities permitted the currency to strengthen, but since the start of 1995 it has been very stable. Monetary conditions turned easier from 1994 to 1995 and interest rates came down. The expansion in credit that followed has brought with it strong gains in the equity and property markets. At this juncture, a natural question to ask might be: what is the likely extent of S$ appreciation in 1996/97 ?

This article begins with a brief review of the connection between balance of payments surpluses and the S$ over the last few years. Since the mid-1980s, strong balance of payments conditions have placed upward pressure on the exchange rate against the US$ -- a characteristic shared by some other Asian currencies. While most other East Asian countries have either loosely pegged their currency to the US$ or heavily managed it, none has followed the Singaporean example of explicitly permitting its currency to appreciate in trade weighted terms -- thereby accommodating the upward market pressures. As a result, the expansion in monetary conditions in Singapore in recent years has not been quite as dramatic as that in some of its neighbours and so CPI inflation has tended to stay more subdued.

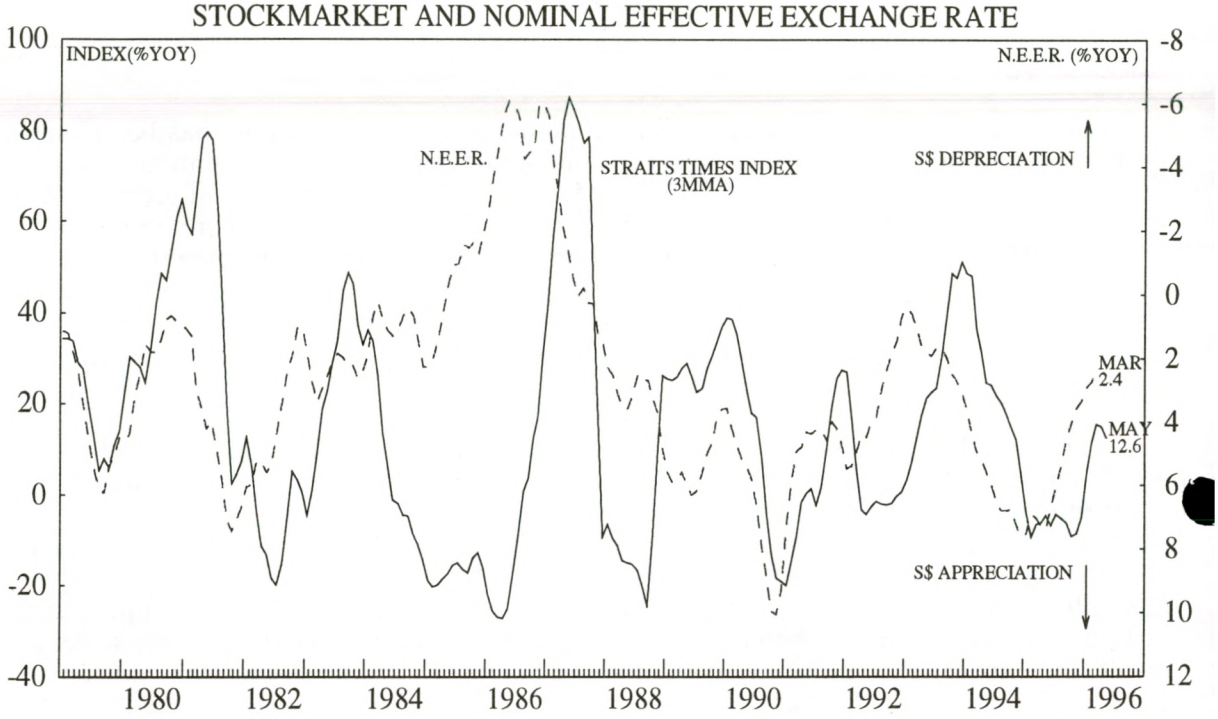
Allowing some appreciation in the trade weighted S$ is one course of action open to the authorities if they seek to dampen the expected appreciation in domestic asset prices in the year ahead. Alternatively, under strong balance of payments pressures they may maintain the same degree of exchange rate stability and induce greater asset price gains. The first chart shows how allowing the trade weighted S$ to appreciate can dampen local equity gains. Over a larger timespan this would also slow the expansion in property prices.

Balance of Payments Pressures

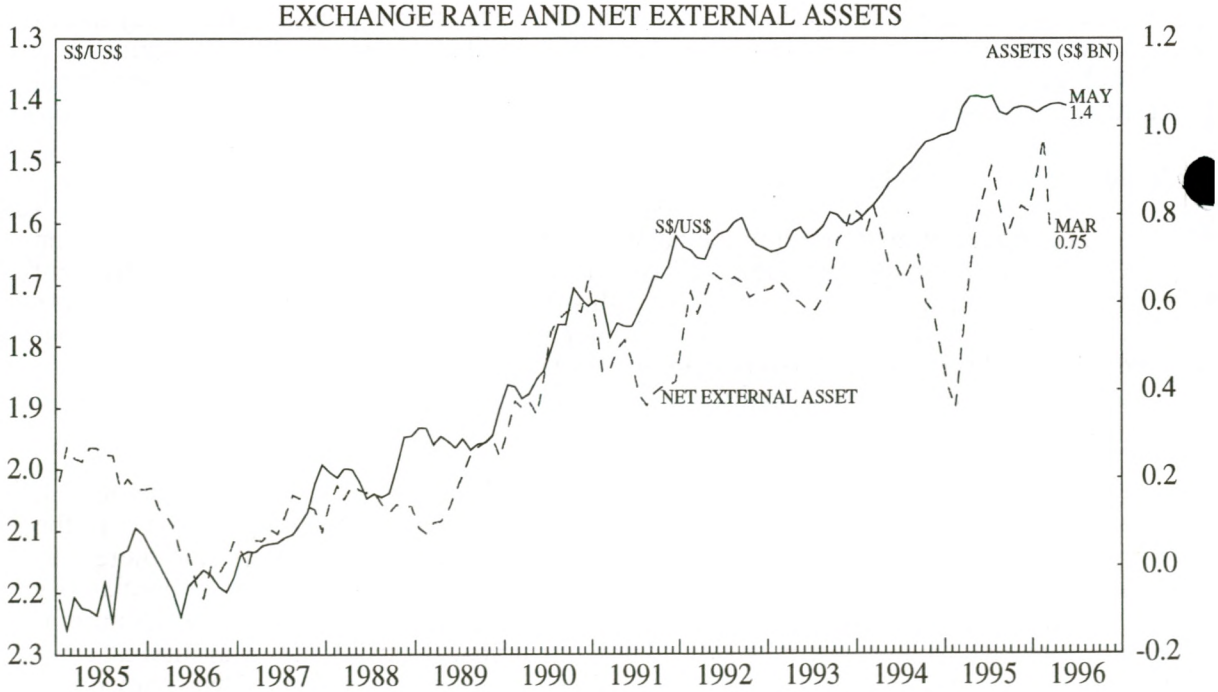
The longer term strength in the balance of payments -- over 5-10 years -- has been derived from two main areas: the strength in foreign capital inflows and the consistent earnings from net services income. Chart 2 illustrates the rise in foreign exchange reserves (balance of payments surpluses) and the appreciation in the S$/$ rate that has accompanied it. Over shorter time horizons spanning a year or so, swings in the merchandise trade deficit have brought about substantial swings in the current account surplus which in turn have affected the balance of payments (chart 3).

In 1994, the boom in exports led to a substantial improvement in the trade deficit. This together with the rise in net services surplus led to a dramatic improvement in the current account surplus such that it reached around 18% of GDP. At that time there was such strong upward pressure on the S$/$ that the authorities allowed it to appreciate by around 8% in 1994. As the authorities let the exchange rate take the strain the accumulation of foreign exchange reserves slowed down that year (chart 2) and local interest rates rose in line with those in the US (chart 4). This exchange rate appreciation was viewed by some as a tightening in monetary conditions, although it would be more accurate to characterise it as being consistent with less stimulative monetary conditions.

SINGAPORE: CHART 1
STOCKMARKET AND NOMINAL EFFECTIVE EXCHANGE RATE



SINGAPORE: CHART 2
EXCHANGE RATE AND NET EXTERNAL ASSETS



SINGAPORE: CHART 3
BALANCE OF PAYMENTS

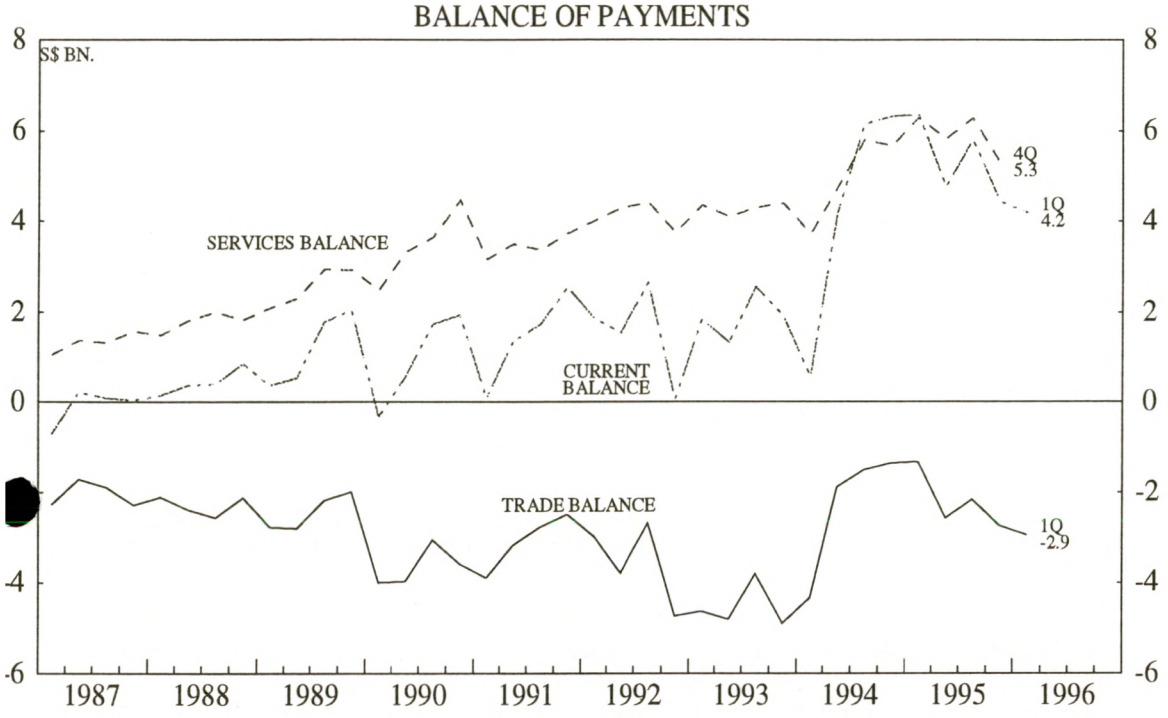
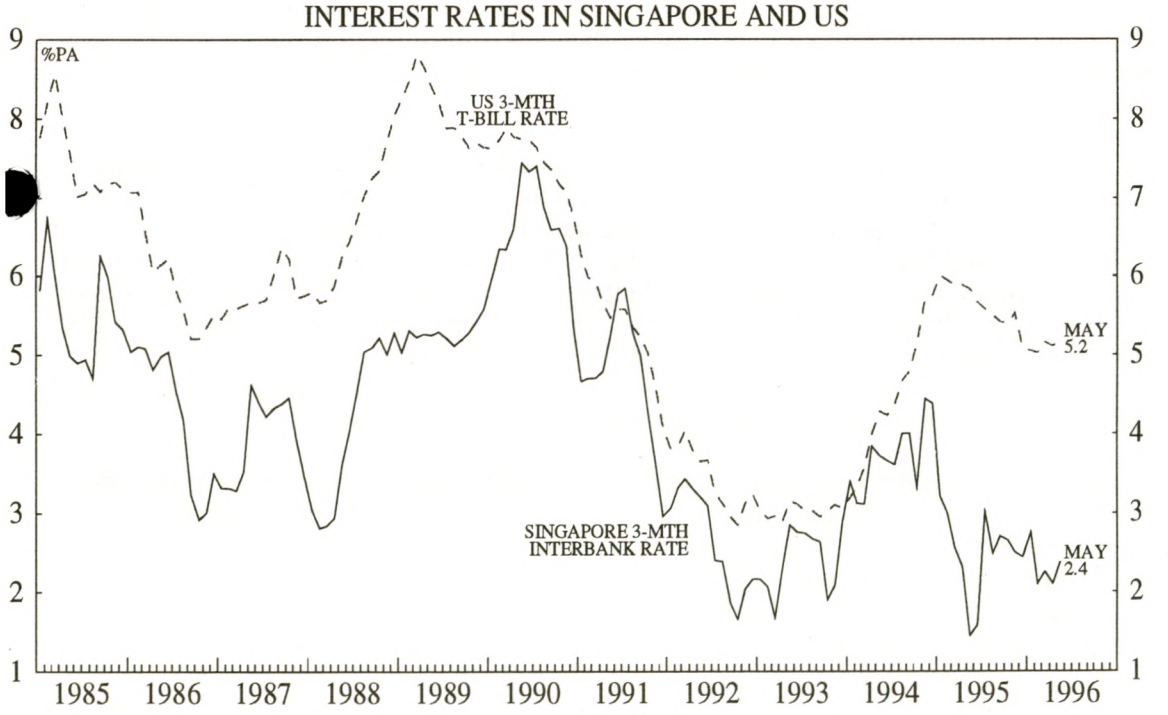
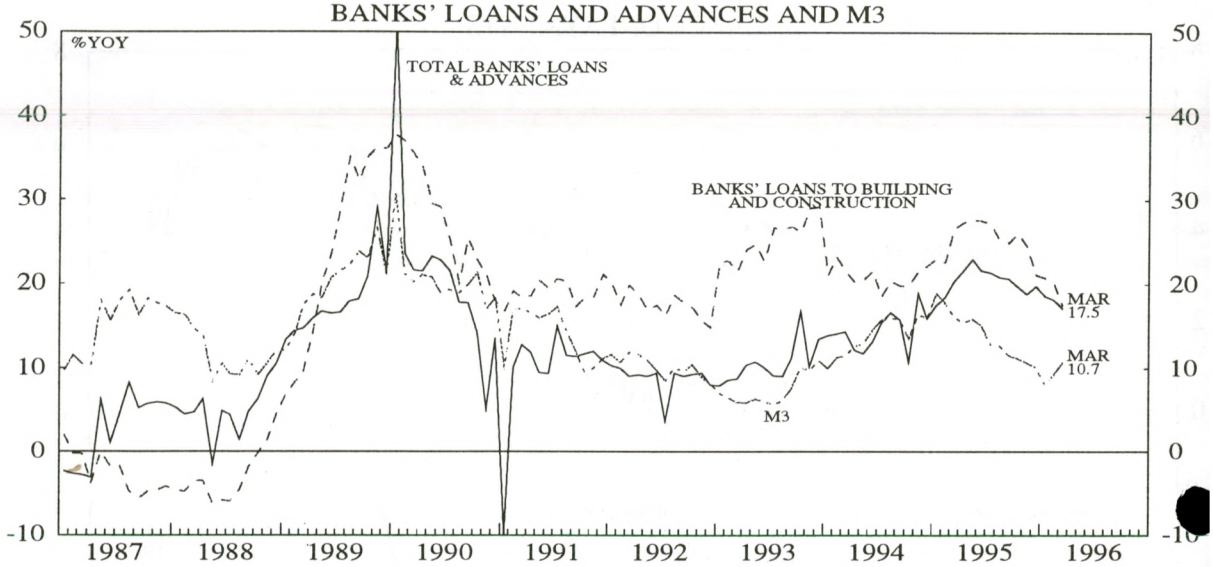


CHART 4
INTEREST RATES IN SINGAPORE AND US



SINGAPORE: CHART 5
BANKS' LOANS AND ADVANCES AND M3

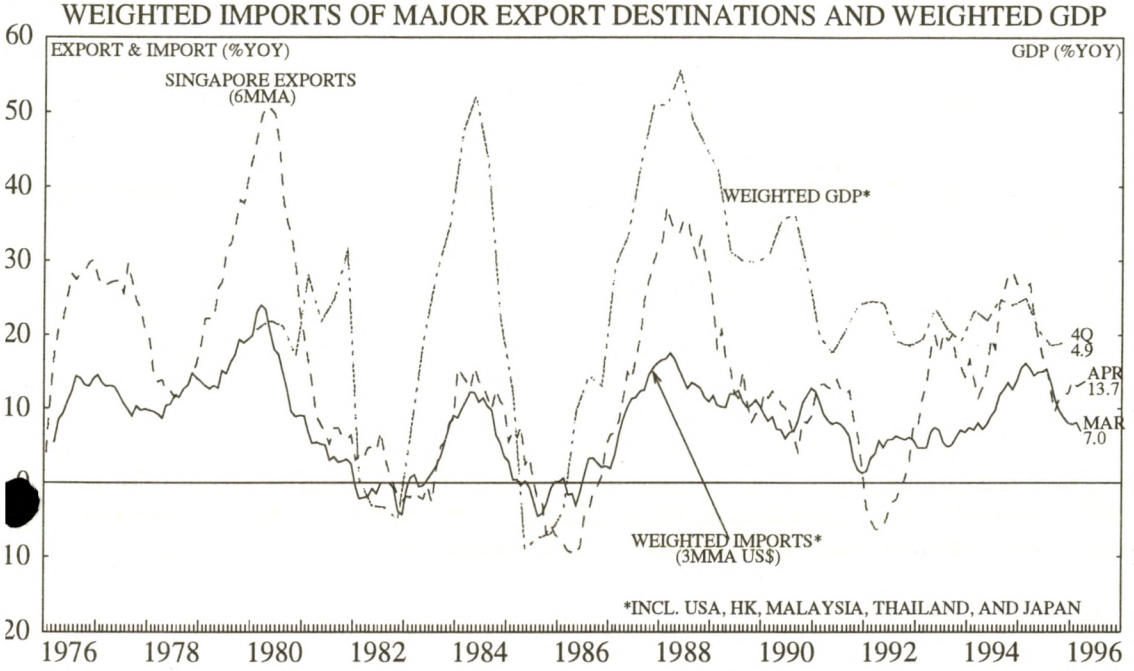


In 1995, the export boom cooled off and the previous improvement in trade started to reverse. The authorities were content to place some form of 'cap' on the S$ appreciation, such that there was virtually no appreciation in the S$/$ rate at all in 1995. The short term interest rate differential with the US widened substantially to between 2-3% in 1995, as local interest rates came down (chart 4). During 1995 credit and monetary conditions expanded to a greater extent and various asset prices showed significant gains. Consumer lending and car prices increased rapidly until the authorities imposed some administrative measures to dampen activity in this area. There has also been stronger activity in the residential property market, although higher demand from foreign residents and the government's policy of encouraging residents to own their own homes have also played a part here (chart 5).

The strong S$ experience of 1994 came about because of strong market pressures. Interest rates would likely have remained low had the S$ not been allowed to appreciate at that time. However, there are times when the authorities are keen to see the S$ stronger than the prevailing balance of payments indicate. Brief periods of intervention to appreciate it can introduce upward moves in local interest rates independent of those in US rates, for a short time. This occurred in 1990 when the S$ appreciated strongly against the US$ as well as in trade weighted terms (by around 8% and 10% respectively). Local short term interest rates moved upwards, rising above those in the US before coming down in step with those in the US from mid-1991 onwards.

Movements in the S$ can be viewed in some instances as a barometer of the underlying balance of payments condition and in others as a measure of the government's objective to see further appreciation which tightens monetary policy. In either case we might expect some appreciation in the S$ (against the US$ and in trade weighted terms) in the year ahead. To gain an insight as to how great this is likely to be requires some assessment firstly of the prospective balance of payments pressures ahead and secondly, whether there are reasons to expect the authorities to view the exchange rate as being 'undervalued,' thereby justifying some appreciation. Equivalently, one could ask whether the authorities would prefer to see higher goods and assets price inflation in S$s or a stronger currency.

SINGAPORE: CHART 6
WEIGHTED IMPORTS OF MAJOR EXPORT DESTINATIONS AND WEIGHTED GDP



The remaining two sections of this article, deal with balance of payments and official stance of the authorities from two angles: the influences over the demand of exports and the demand for property.

Influences on Exports

With export revenues equivalent to around 1.4 times GDP, Singapore's economic growth remains highly sensitive to its export performance. This is likely to remain the case given the longer term trend of relocation of exporters to Singapore, especially from Japan. Higher foreign investment in both manufacturing and service sectors represents a future source of export income and demand for S$s.

Perhaps the most important factor governing the rate of Singapore's export growth is the income growth in its export destinations. Chart 6 shows import demand and GDP growth in Singapore's top 5 destinations, each weighted by GDP. The cycle in Singapore exports in US$ terms tends to follow the pattern of import demand in the countries of destination quite closely. The economic slowing in the US, HK and Thailand over the last 6 months has had an adverse effect on Singapore's exports already. This trend may continue in the immediate months ahead, however, a broader economic recovery across the OECD should reverse this trend over the next 12-18 months.

The largest single export destination is still the US at 18%, although its direct share of Singapore's exports has become more diluted in the last decade (chart 7). Asia excluding Japan has become a significant destination and it continues to grow as a share of Singapore's export base, currently at 40%. Around half of this is to Malaysia. Some exports to non-Japan Asia will be components which form one part of an assembly of a product to be exported outside Asia. In this sense, some of Singapore's exports to Asia are indirectly bound for the US and other non-Asian destinations.

Notwithstanding the steadily diminishing share of exports to the US, Singaporean exports remain sensitive to demand conditions there. In the area of electronic products and components (which account for around 36% of total exports) there is a broadly positive correlation between the new orders for electrical equipment in the US and Singaporean exports of these products. The importance of this area to Singapore can be seen from charts 8 and 9. The slump in these exports in 1991-92 and more recently in late 1994 goes some way to explaining the less rapid pace of real GDP growth at these times. On this basis, if the recent slowdown in US orders for electronic equipment and computers continues for much longer then there could be some slowdown in this sector and GDP could follow suit as a result in the nearterm.

Japan accounts for around 8-9% of Singapore's total exports, a share which has been relatively stable for the last decade. As Japan's economic recovery gathers steam and as Japanese manufacturers increase their presence in Singapore, this share will likely rise.

Some commentators consider the tendency for the S$ to appreciate in itself an important determinant of export demand and that therefore a slow appreciation will stimulate export growth and vice versa. For example the large appreciation in the early 1980s preceded the sluggish export growth at that time and the strong appreciation in the late 1980s preceded more subdued export growth in the years that followed (chart 10). However, overall export competitiveness needs to be assessed in real terms, that is, accounting for the inflation in local cost pressures.

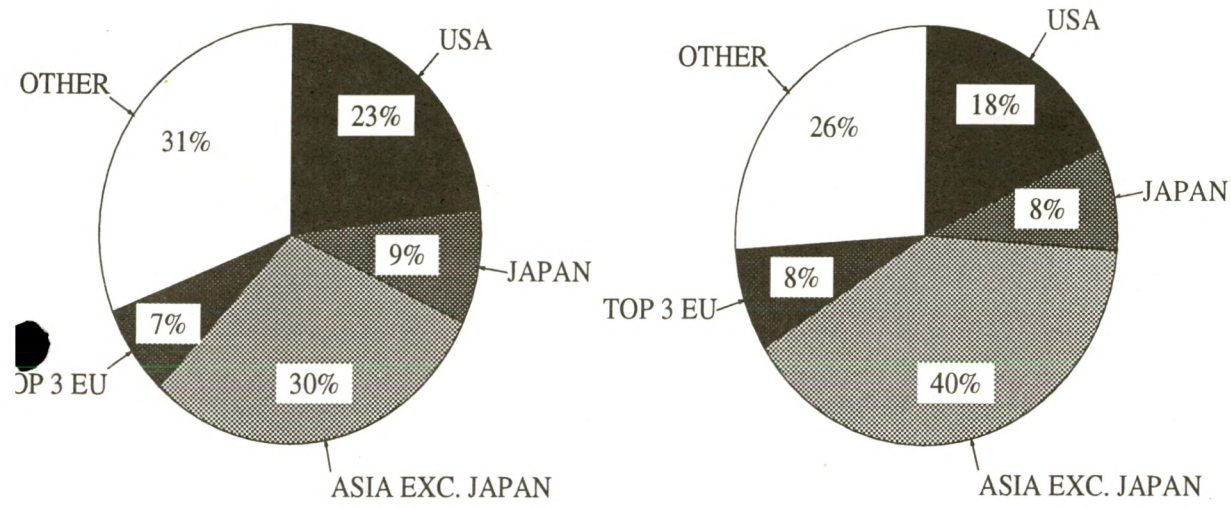
Chart 11 illustrates how the S$ in trade weighted terms (the nominal effective exchange rate) has continued to appreciate with brief pauses since the mid-1980s. By contrast the real effective exchange rate has remained relatively stable. The real effective exchange rate is the trade weighted index for the S$ adjusted for movements in the wholesale price indices (WPI) in Singapore and its 8 major trading partners. This index has been comparatively stable since the mid-1980s, indicating that the rise in the WPI in Singapore's trading partners over this time has exceeded that in Singapore by the extent of the appreciation in the S$. Conversely, the nominal exchange rate appreciation has been sufficient to absorb or choke-off the domestic inflation that would have resulted from a more stable nominal exchange rate. In conclusion, the appreciation in the nominal trade weighted S$ is unlikely to have been a major factor governing merchandise export growth and that external income growth is a more dominant effect.

Property Market Influences

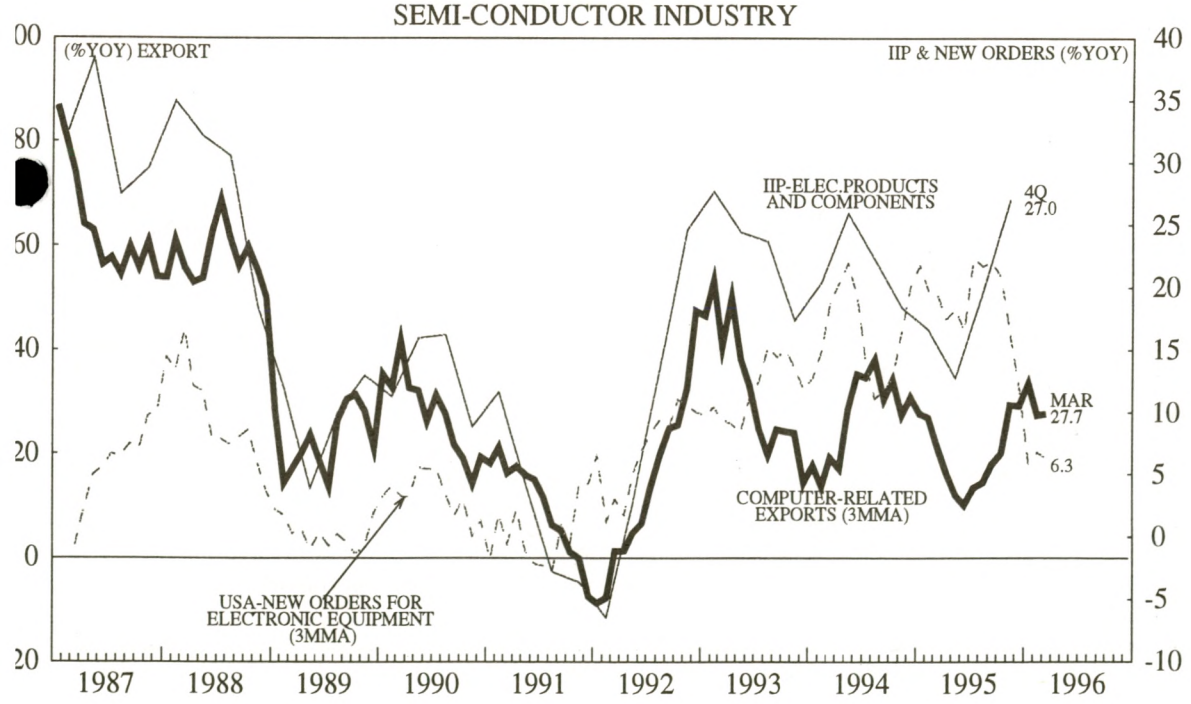
The substantial rise in foreign direct investment in recent years in the manufacturing and services sectors has pushed up commercial office property prices and rents to new highs (chart 12). Residential property prices have also seen strong gains because of a rise in both domestic and foreign demand. Domestic demand has been ignited by factors such as: the ability of residents to use more of their accumulated savings at the Central Provident Fund (CPF) to purchase a house/flat, and, the change in 1993 which allowed HDB flats to be valued at market prices rather than at cost.

Given the strength in property prices in January, the authorities tried to restrain demand by disqualifying CPF savings from the minimum 20% initial downpayment ('quantum') for a mortgage and by increasing the minimum downpayment itself from 10% to 20%. More recently in May, the authorities introduced a package of measures which was designed to reduce the 'excess' demand and penalise speculative elements in the property market. The package consists of the following measures.

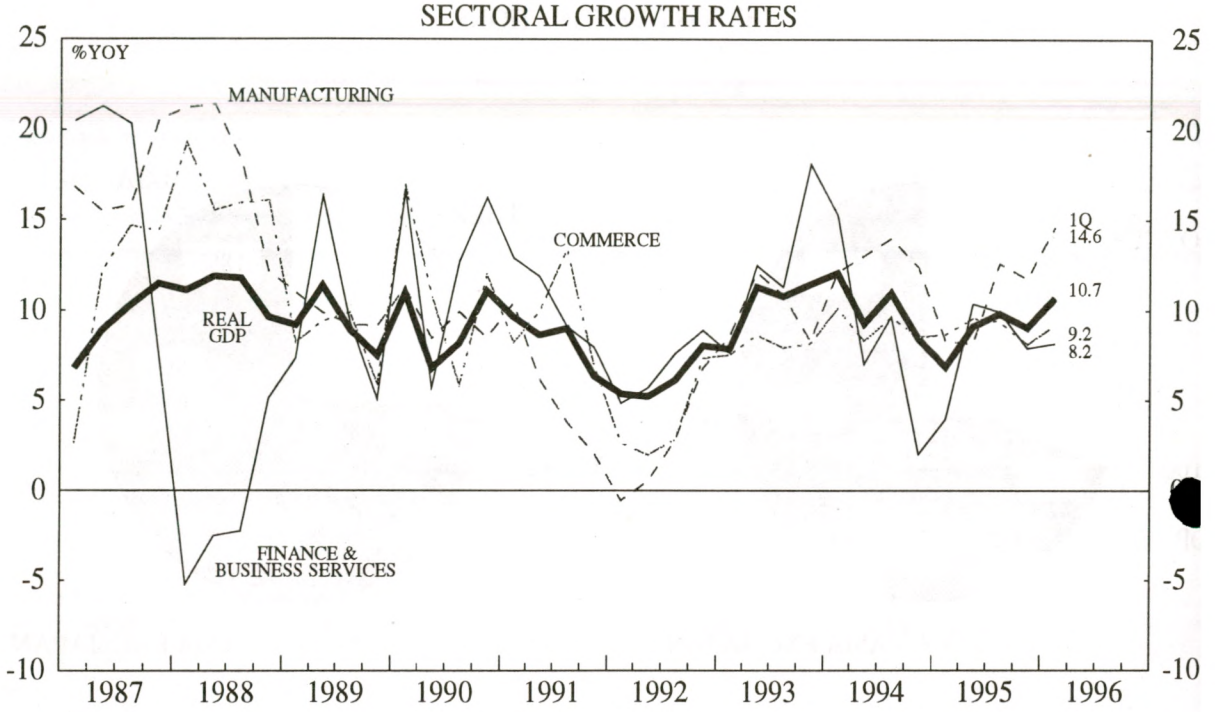
SINGAPORE: CHART 7
EXPORT DESTINATIONS



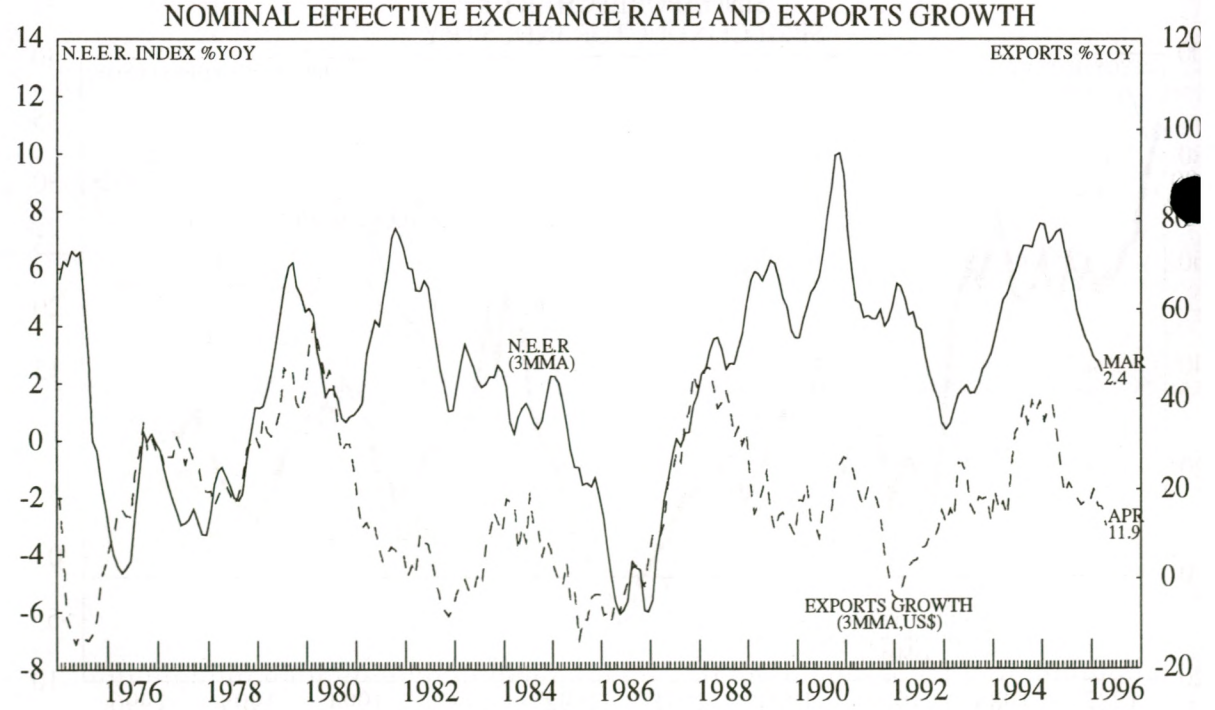
SINGAPORE: CHART 8
SEMI-CONDUCTOR INDUSTRY



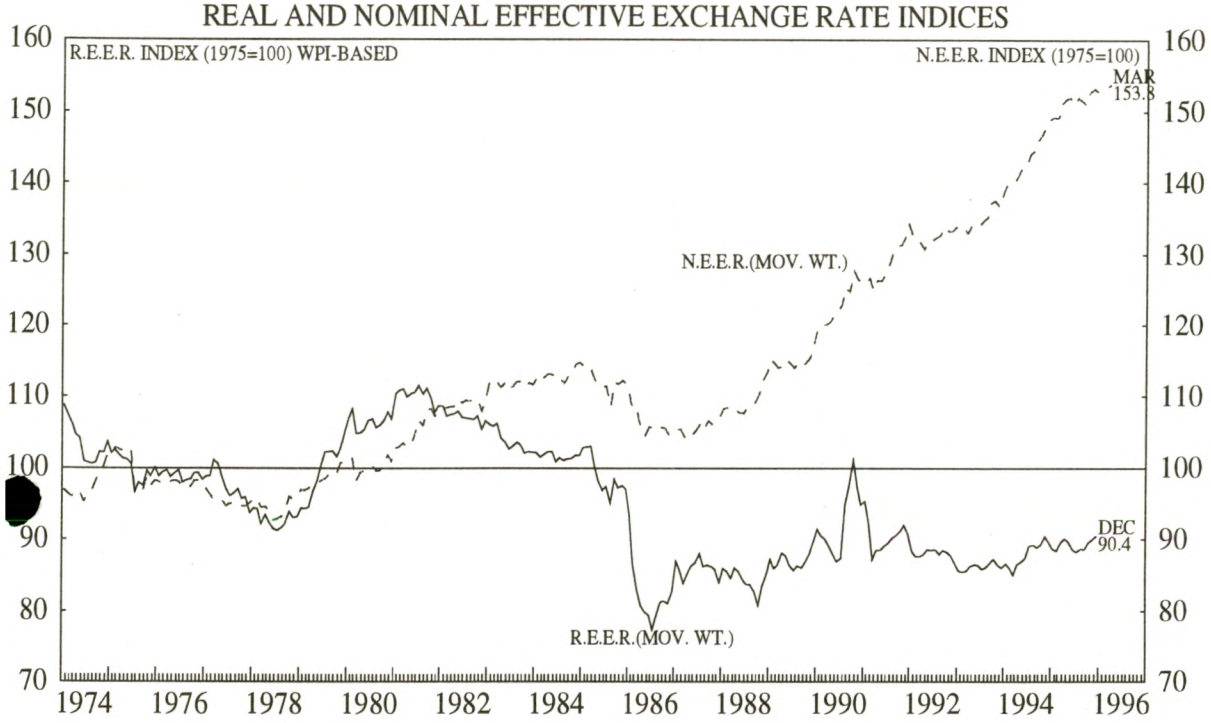
SINGAPORE: CHART 9
SECTORAL GROWTH RATES



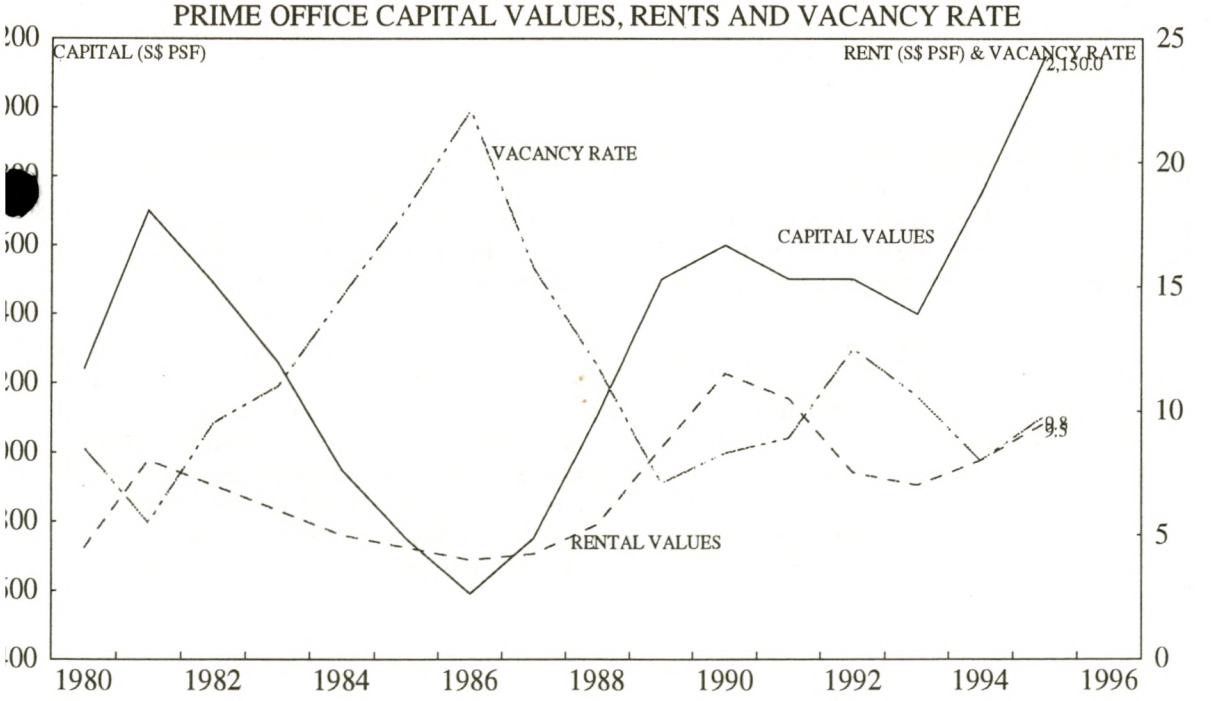
SINGAPORE: CHART 10
NOMINAL EFFECTIVE EXCHANGE RATE AND EXPORTS GROWTH



SINGAPORE: CHART 11
REAL AND NOMINAL EFFECTIVE EXCHANGE RATE INDICES



SINGAPORE: CHART 12
PRIME OFFICE CAPITAL VALUES, RENTS AND VACANCY RATE



(1) The MAS will enforce the 80% limit on mortgage financing. Permanent residents can have just one S$ loan to buy a residential property for owner occupation only, i.e. residents cannot have more than one mortgage running simultaneously. S$ loans to foreigners are more restricted.

(2) The Government will introduce a new tax on any property gains which are realised within 3 years of purchase. All residential and non-residential properties will be subject to a tax on the gain equivalent to 100% if sold in the first year, 66% if in the second and 33% if in the third. In addition, tax on property gains is withheld from foreigners at 15% of transacted value, if they sell within the first year of purchase, 10% if sold within second year and 15% if sold within third year. Stamp duties were also raised.

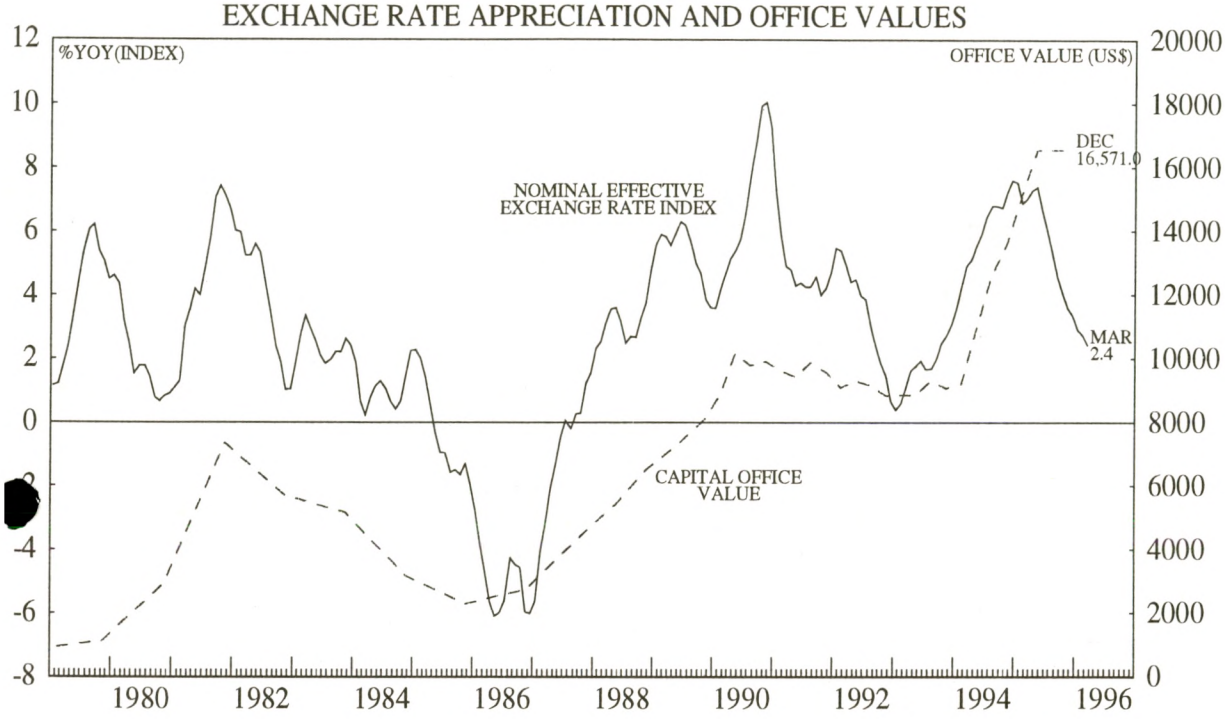
(3) The Government is to increase land sales for private properties from 6000 to 7-8000 units per year. In addition, it will launch an Executive Condominium Scheme in June, which is designed to make condominiums more affordable to permanent residents. As with first time HDB resale purchases, because they are buying from the Government, first time buyers will be eligible for a S$40,000 CPF subsidy which reduces the finance they need to obtain from banks.

These measures may have some dampening effect on property market activity in the months ahead, but are unlikely to slow the sector down significantly. Heavier handed policies to dampen the property market would run against the government's ongoing objective of encouraging residents to own their own home. However, there are some additional changes that could be made to reduce the affordability of property to certain participants.These would include: reducing the employers CPF contribution (forcing households to borrow more for a property) or enforcing a higher cash downpayment ('quantum') for various types of mortgage applicant. Local interest rates remain historically low and in the absence of an upswing in US interest rates they are unlikely to rise sufficiently to reduce overall activity in the property market. However, if the S$ was permitted to appreciate this would screen out some of the foreign demand.

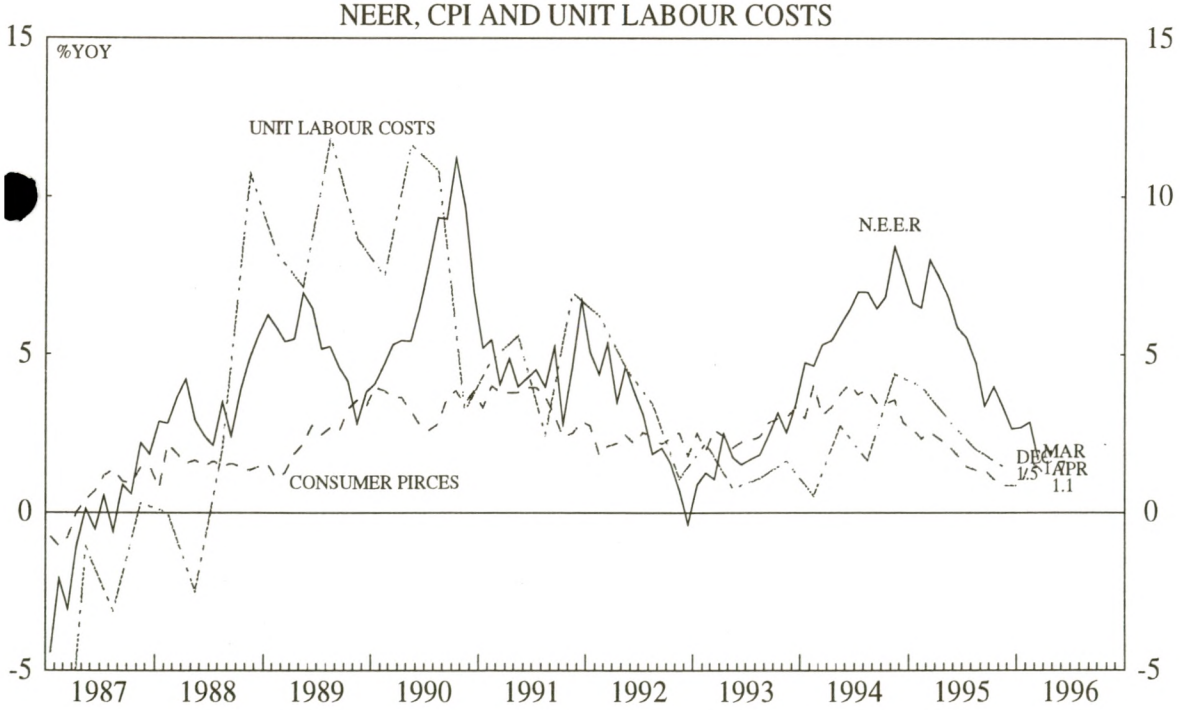
Looking back over the last 15-20 years, the sustained appreciation of property values has at some stage been followed by stronger S$ appreciation, as in 1980-81 and 1989-90. In the lead up to and during these years the S$ exchange rate in trade weighted terms and against the US$ appreciated by over 5% (chart 13). If it appears to the authorities that Singapore is reentering a property boom of at least similar magnitude to the previous two in the next year, then the S$ may be considered in this sense undervalued.

Another basis for permitting S$ appreciation is the likely direction of the inflation rate of local costs and prices (chart 14). It is one aim of Government policy that the exchange rate appreciates to offset the higher demand for S$ that would otherwise translate into higher local inflation. At times when the rate of inflation of the CPI and unit labour costs accelerates, there would be a greater desire to see this matched with a degree of S$ appreciation. This way, higher foreign demand for locally produced goods results in a stronger currency rather than higher local inflation. In addition, if the S$ appreciation is accompanied by higher local interest rates then domestic demand is reined in as well.

SINGAPORE: CHART 13
EXCHANGE RATE APPRECIATION AND OFFICE VALUES



SINGAPORE: CHART 14
NEER, CPI AND UNIT LABOUR COSTS



At present it appears that upward cost pressures are fairly muted. However, the recent and ongoing appreciation in local asset prices follows the upswing in M2 and credit growth in 1994-95 (chart 5). At some stage in the year ahead, this will translate to stronger consumption expenditures and lead to a strengthening in CPI inflation. This would likely prompt the authorities to let the S$ appreciate to limit further acceleration in asset and consumer prices. However, to actually bring about tighter monetary conditions would require higher interest rates and this is unlikely until upward cost pressures become more persistent. In addition, raising local interest rates when the balance of payments pressures are strengthening would entail a more substantial appreciation in the S$. Nevertheless, as can be seen from chart 1, any S$ appreciation which lies around the corner does not bode well for the equity market

SUMMARY AND CONCLUSIONS: Appreciation by at least 5% in the trade weighted S$ appears likely in the year ahead on the basis that the residential and commercial property markets are likely to remain strong, CPI inflation will accelerate and that export growth will pick up towards the end of this year and into the next. However there are a number of factors that will act to delay this. They include: further slowdown in exports in the months ahead and the currently subdued pace of inflation in the CPI and in labour costs. The stronger inflation ahead will signal the onset of stronger domestic demand pressures which up till recently had only been manifest in credit growth and asset prices. Although gains in the equity market have been minimal since the start of the year, there is still scope for limited gains. However, once the S$ resumes a trend of appreciation the chances of a sustained rally in the equity market are small.

THAILAND
A PROTRACTED CYCLE RAISES STRUCTURAL ISSUES

Introduction

This article examines progress of the economic cycle in Thailand over the past six months and touches on some of the structural issues which are currently the source of much local debate. In essence, the article attempts to address an apparently simple question: Why has the Bank of Thailand (BoT) faced such difficulty in dampening growth momentum over the past eighteen months? Part of the answer goes to the core of the debate on currency reform in Thailand (which could equally apply to other countries in Asia). It is widely accepted that excess liquidity in Thailand has been a key factor undermining monetary policy and prolonging the investment boom. Excess liquidity in turn has been generated through perceptions of high yielding Thai Baht denominated assets alongside a stable exchange rate regime. The solution most frequently offered is to diminish the attractiveness of Thai domestic assets to foreigners by inducing greater exchange rate volatility.

It is argued here that while greater currency flexibility is an essential step forward in the BoT's battle against excess liquidity, any moves at this stage, while Thailand's interest rate cycle remains somewhat decoupled from those of its "anchor" countries, could yield unpredictable and undesirable results. Such uncertainty could in turn be acutely negative for the export sector. On balance, therefore, we expect no major change to the existing currency regime in the immediate future, although the the BoT should not miss an imminent opportunity, as money growth slows and the trade balance improves, to implement currency reform.

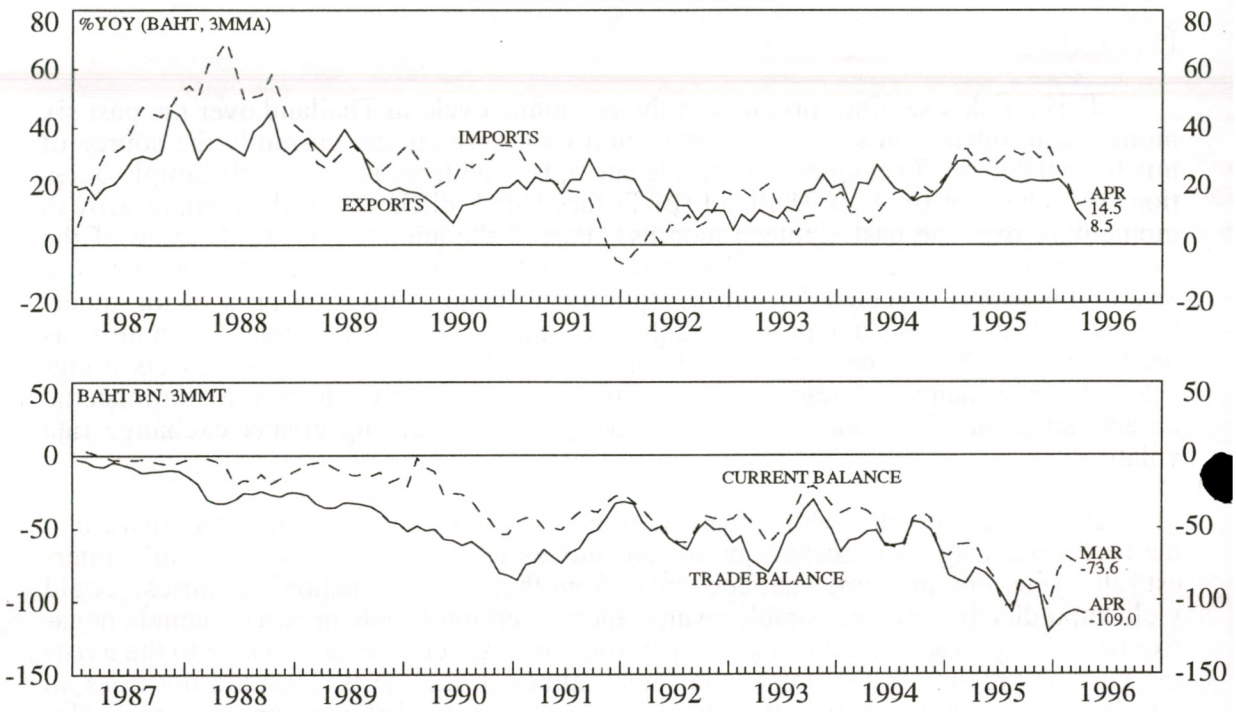
A second factor currently blunting the efficacy of monetary policy is inherent within the use of quantitative controls on banks' balance sheets. Reserve requirements are an acceptable tool as long as the BoT is unhesitatingly willing to accept the interest rates consequences of such measures: lower deposit rates and, eventually, lower loan rates. These developments, however, do not sit well with apparent problems in mobilising domestic savings, and Thailand's current cyclical position .

Structural issues aside, the cyclical downswing appears to have temporarily stalled after signs of a steady slowdown over 1995. Import growth continues to weaken, but export growth appears to be weakening more quickly. Poor performance of the stockmarket is at least partly indicating the impact of tight money on earnings. We expect that the economy itself will start showing more visible signs of slowing in 1996H2, during which time the domestic interest rates are likely to fall further and the stock market may also gain from a welcome release of liquidity.

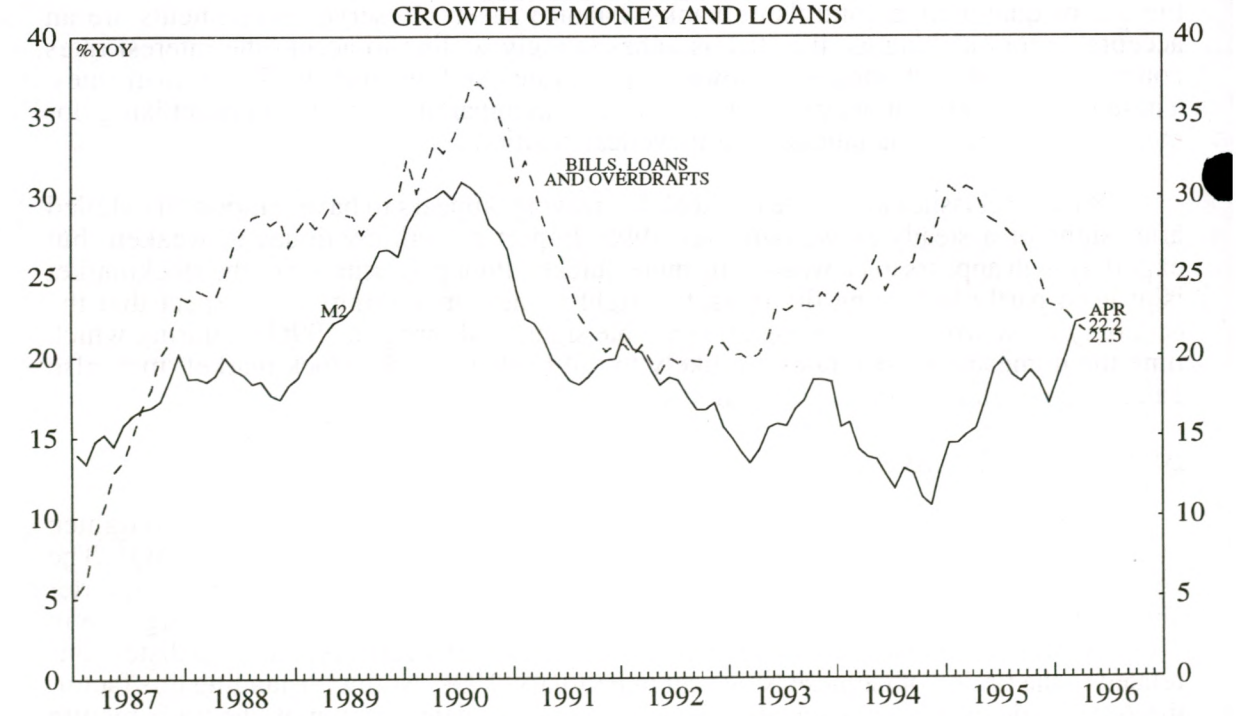
An Update on the Cycle

The Bank of Thailand's (BoT) recent announcement of further measures to tighten monetary policy came on the back of a mixed set of economic indicators in 1996Q1. The customs cleared trade deficit, shown in Chart 1, narrowed slightly over the first quarter although the current account balance improved more markedly. The sharp divergence in y-o-y growth rates between trade and current accounts partly reflects statistical distortions related to the timing of Chinese New year in February 1996. Nothwithstanding this factor, the April trade data did not suggest any change in trend deterioration of the trade picture since late 1994.

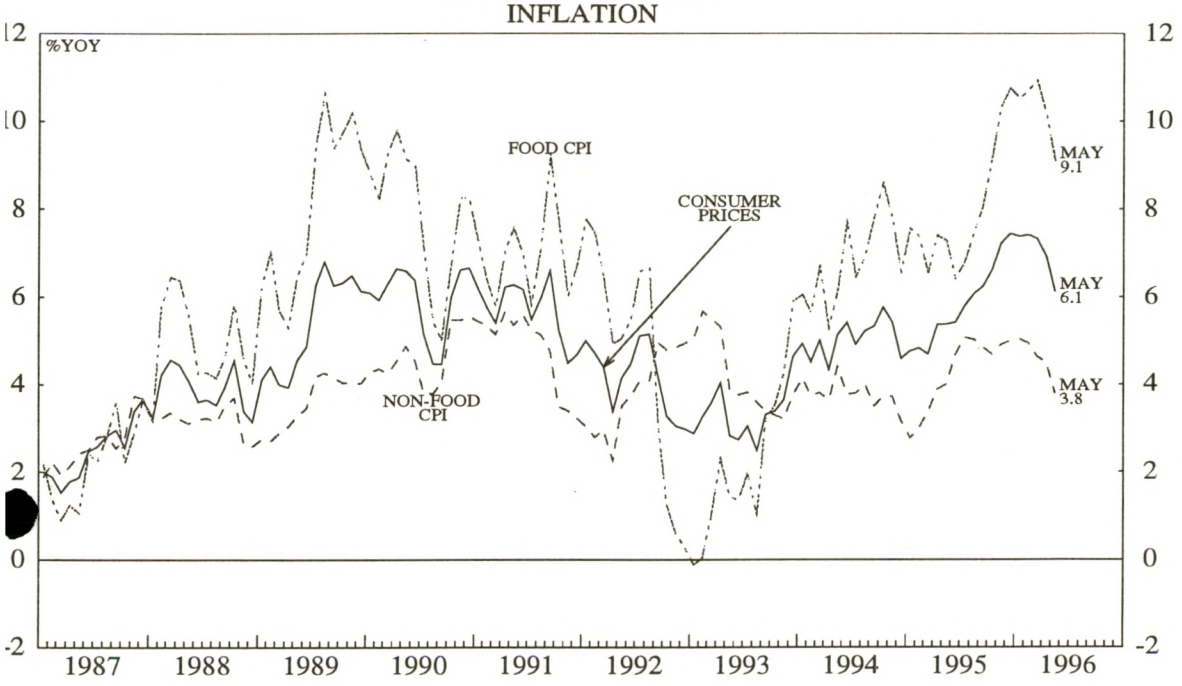
THAILAND: CHART 1
TRADE PERFORMANCE



THAILAND: CHART 2
GROWTH OF MONEY AND LOANS



THAILAND: CHART 3
INFLATION



Money supply and loan growth indicators shown in Chart 2 were equally mixed. Loan growth continued to decelerate, while M2 growth picked up sharply, partly in response to capital inflows -- the latter confirmed by the ongoing surpluses on the balance of payments in early 1996. The only source of comfort at this stage appeared within the latest inflation numbers shown in Chart 3. Headline CPI inflation decelerated markedly in May as high base effects from last year's flood-related crop damage started to drop out of the index calculation. Base effects were also partly responsible for an easing in non-food components of the CPI.

The Currency Reform Debate

The spate of mixed economic indicators, and BoT's announcements of further monetary measures to limit credit growth and capital inflows, naturally resurrected debate over the efficacy of existing monetary policy arrangements. The latest round of reserve requirement hikes in May were largely expected by financial markets, but rumour of an imminent widening of Thai Baht intervention bands was greeted with interest; leading to speculation of much broader currency reform.

The currency reform debate in Thailand has centred around the need for more flexibility, as a means of enhancing the risk on Baht denominated assets, and thus preventing the build-up of excessive liquidity. We have previously shown in this publication that the emergence of excess liquidity across ASEAN (see AMM Vol 19 No. 5) is not a result of regional exchange rate regimes per se (ie fixed vs floating), but more the way they are managed with respect to domestic economic policy objectives. Across Asia, policy authorities have attempted to protect exporters, by managing their exchange rates within narrow ranges (Chart 4) against respective nominal anchor currencies. In most cases, the US dollar has acted as nominal anchor, although in Thailand the authorities target a weighted basket, which includes mostly the dollar, but also the Yen and Deutschemark.

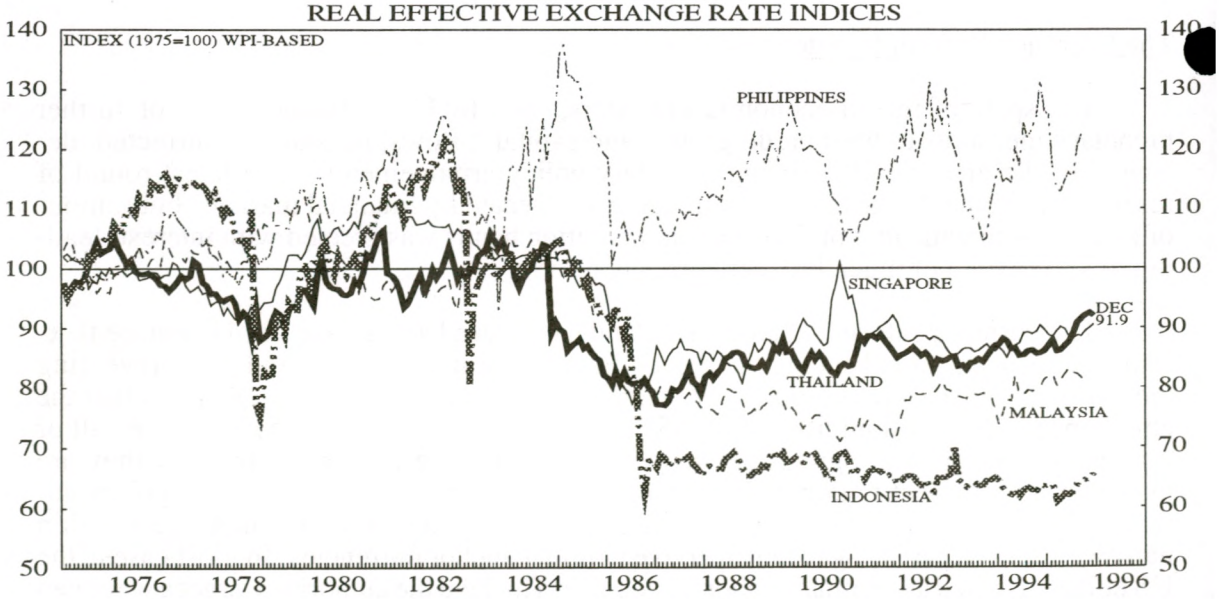
While attempting to maintain currency stability, domestic interest rates have often diverged significanlty from the anchor country as late-stage symptoms of the monetary cycle, inflation and current account deficits have become evident. In Thailand, the emergence of such a lucrative mix of interest rates, and exchange rates, has resulted in the accumulation of large balance of payments surpluses (Chart 5), alongside a burgeoning trade deficit and inflation. The BoT has sensibly refrained from undertaking substantial sterilisation operations and the result has typically been excess liquidity combined with pressure for interest rates to fall somewhat countercyclically.

The Perils of Mis-timing Currency Reform

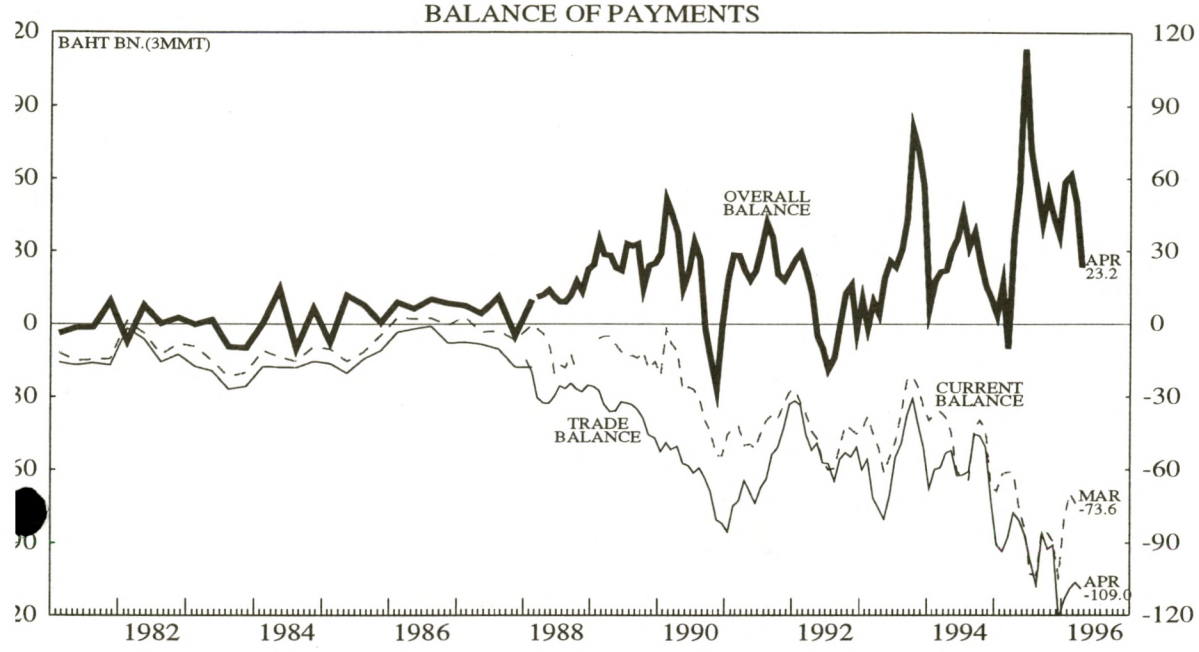
Allowing greater Thai Baht flexibility against its basket, for instance through the widening of currency fluctuation bands, appears an attractive option for the BoT to pursue, although any such modification at this stage of the cycle carries potentially high risks. Recent experience within the European Exchange Rate Mechanism (and indeed in Thailand prior to devaluation of the Baht in 1984) has shown that currency markets are quick to test the defensive resolve of monetary authorities, when there is a perceived inconsistency between domestic monetary frameworks and macroeconomic fundamentals. In the case of Thailand, such perceptions are likely to be most acute at a time such as now, when the economy is in dis-equilibrium.

At present, it would appear that the need for high interest interest rates and faltering export growth are each pulling the Baht in opposite directions. Piecemeal changes to existing parities at this time could, therefore, yield great instability. A revaluation of the Baht, for instance, would be perceived to be inconsistent with a worsening trade picture, and a potential narrowing in US-Thai interest differentials; a massive capital outflow could be triggered as a result. A devaluation of the Baht, on the other hand, would be wrong to implement against the backdrop of strong money supply growth. With these risks in mind, modifications to the currency regime are probably best delayed until such time as macroeconomic fundamentals in Thailand, and the US converge a little further.

THAILAND: CHART 4
REAL EFFECTIVE EXCHANGE RATE INDICES



THAILAND: CHART 5
BALANCE OF PAYMENTS



Currency Unlikely to Float

What impact would a revaluation of the exchange rate have on the real economy? This would depend on the price sensitivity of exports, exporters' ability to adapt in the face of lost competitiveness (by producing higher value added products), and the extent to which the corporate sector generally remains unhedged against currency risks. Chart 6 shows a modified model for Thai exports based on a version published earlier (see AMM Vol19,No3). The coefficient on the real effective exchange rate (REER) implies that exports are highly sensitive to changes in the REER with a twelve month lag.

While it is not obvious that a revaluation of the Baht is imminent, the export model implies that such a move, by accident or design, could be to detrimental to Thai export performance. Moreover, skill sets implied by the concentration of exports within agriculture and manufacturing, shown in Table 1, suggest that a swift evolution to producing higher value-added products is unlikely in the event of an exchange rate squeeze. Data on corporate sector unhedged exposure to foreign currency risks are not published, but the explosion of foreign currency lending, since the introduction of Bangkok International Banking Facilities in 1993, suggests the possibility of sizeable such exposures. In an attempt to this address this problem, the BoT instructed banks, in November 1995, to take all unhedged components of customer loans onto their own balance sheets; compelling banks to absorb the capital risks associated with unhedged lending.

Will the BoT decide that the need for greater monetary policy control outweighs exporters' needs for currency stability? We have argued so far that major reform at this stage could be destabilising for currency markets. Moreover, the export sector is not mature enough as yet to sustain adverse price shocks. Taken together, these considerations potentially rule out moves towards either a substantial revaluation of the Baht or fully floating the currency, in the near future. A devaluation of the Baht could be viewed as slightly more credible in the medium term, but not while money supply is accelerating.

THAILAND: CHART 6
ACTUAL AND PREDICTED EXPORTS GROWTH

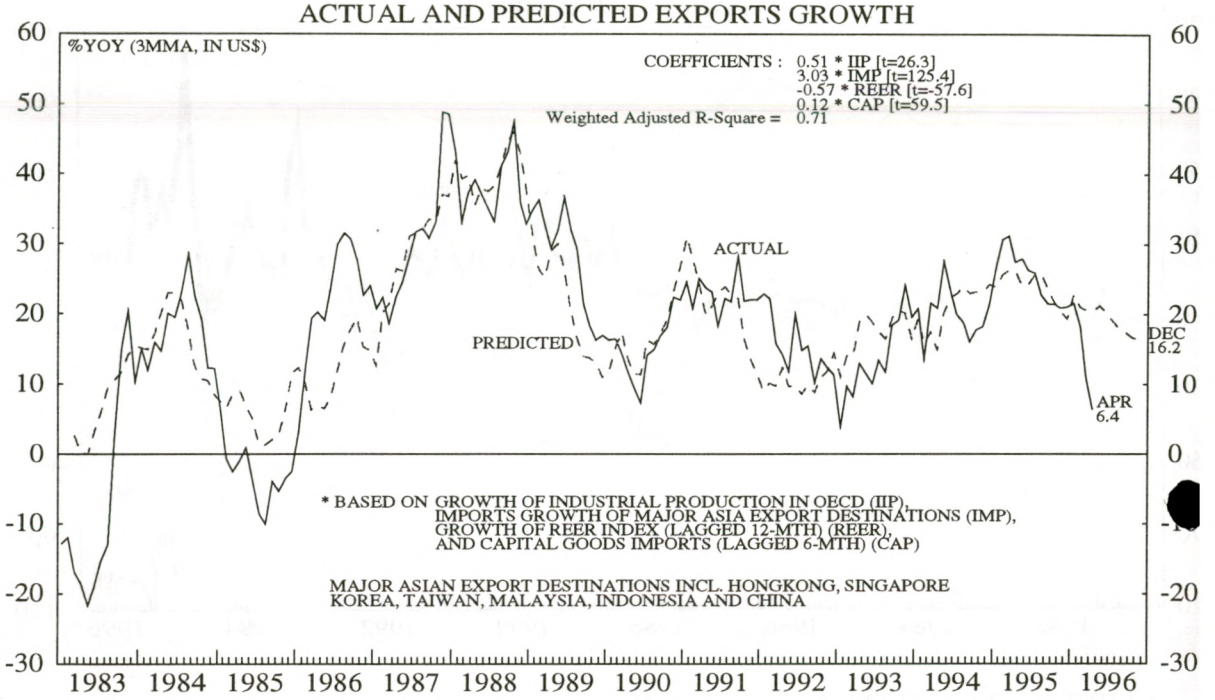


TABLE 1

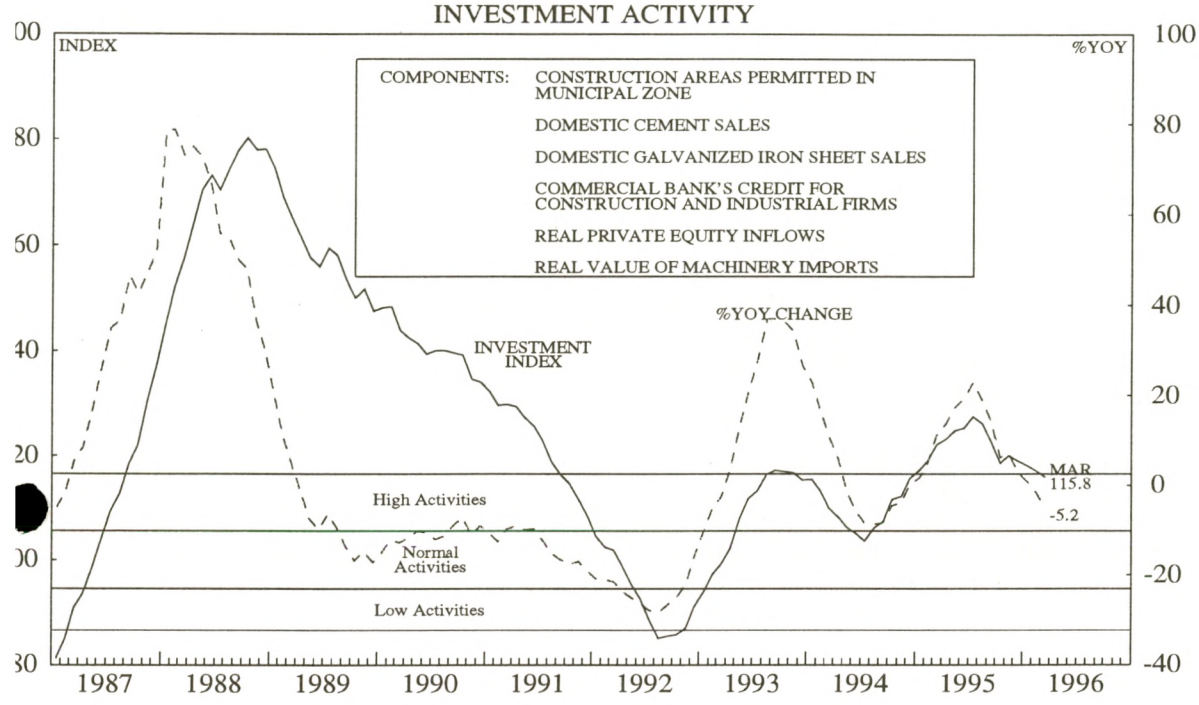
EXPORT COMPOSITION AND DESTINATIONS

	Export Items (as % of Total)	
	1989	1995
Food	34	19
Crude materials	7	6
Chemicals	1	3
Manufactured Goods*	18	18
Machinery	18	34
Misc. Manufactured	20	18
Other	2	5
	100	100

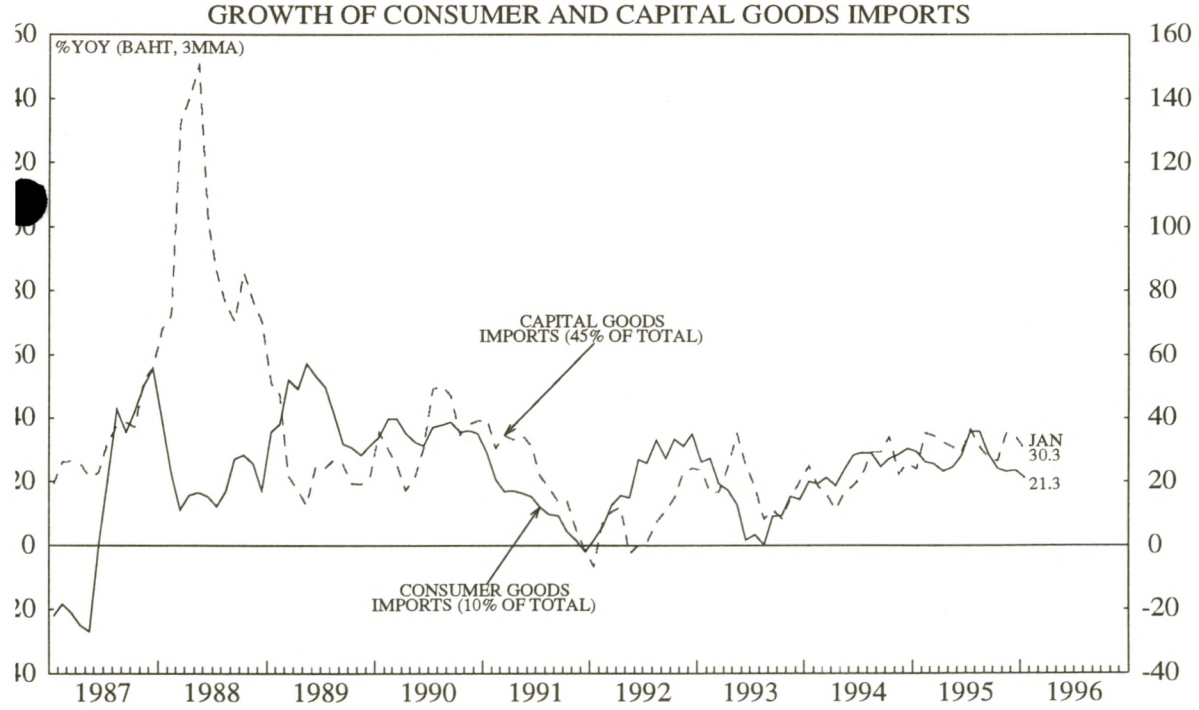
	Export Destinations (as % of Total)	
	1989	1995
Japan	17	17
NAFTA	23	19
EU	19	15
ASEAN	12	19
Asia**	10	15
Other	19	15
	100	100

* Including computer related parts.
** Asia includes Indochina, Hong Kong, S. Korea, Taiwan and China.

THAILAND: CHART 7
INVESTMENT ACTIVITY



THAILAND: CHART 8
GROWTH OF CONSUMER AND CAPITAL GOODS IMPORTS



An Imminent Opportunity

In practise, therefore, we expect the BoT will probably delay major currency reform for the time being, choosing instead to widen the bands of fluctuation progressively later in this cycle. The opportune moment to effect such a transition may not be so far away as the monetary cycle in Thailand cools more noticeably, and global growth gathers momentum by late 1997.

The collapse in export growth over 1996Q1 is likely to reverse partially in the second half of 1996, fueled by growth in Asia, and exports to Japan, although the model forecasts an overall deceleration in export growth over 1996. At least part of the deceleration in export growth so far is reflecting an appreciation of the real effective exchange rate which should remain a negative influence into early 1997. Other negative factors include the general slowdown in OECD import growth (outside Japan), and a collapse in semiconductor prices. Elsewhere, dismal stock market earnings suggest that domestic demand is also easing. It is difficult to gauge the pace of investment activity on a timely basis because of the lack of data although BoT's investment index in Chart 7, a partial proxy, has been decelerating since early 1995. These three factors suggest that capital goods imports (Chart 8), around 45% of total imports, could also slow sharply over 1996. Better export growth later in 1996 and much slower import growth could improve the trade balance later in 1996 and early 1997 -- in the same way, but perhaps not to the same degree, as in 1991 and 1993.

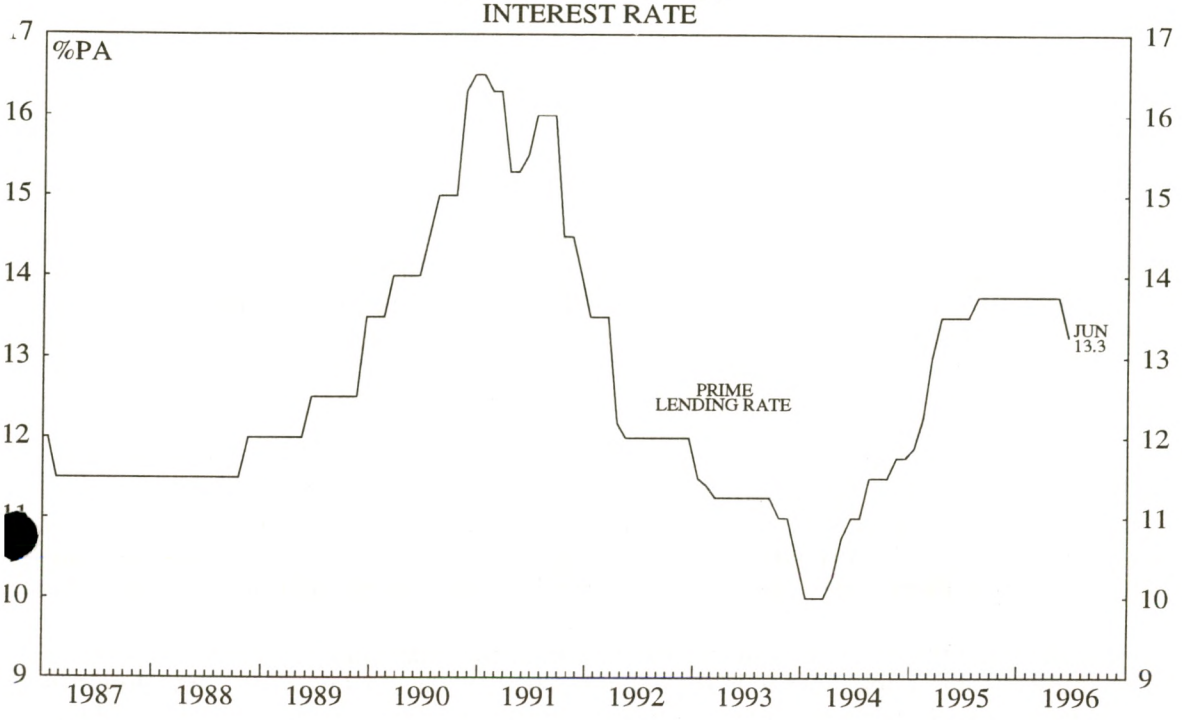
However, money supply needs to decelerate much more markedly, in the near-term before any currency reform is credible. This in turn requires slower credit growth and much greater convergence in US-Thai interest cycles. While credit growth should continue to slow over the next six months, it is unlikely that the US-Thai interest rate cycles will converge sufficiently until 1997H2 -- when much stronger recovery in the US and other OECD countries is expected, and by which time Thai interest rates will have eased substantially.

Reserve Requirements Lower Interest Rates

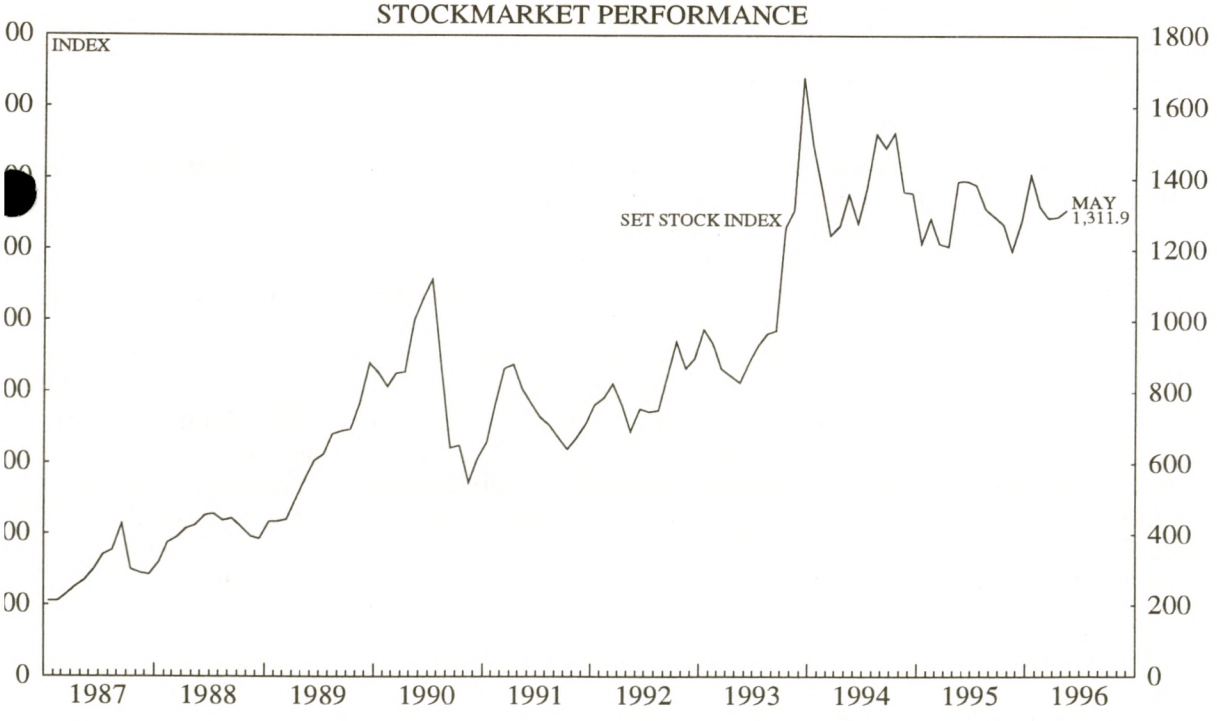
The BoT's methods for monetary control so far have been largely quantitative, confined mainly to adjusting reserve requirements on domestic and foreign currency deposits of banks, and lately finance houses. The BoT has also issued qualitative guidelines, on foreign currency lending, limiting this to "productive" sectors only. Controlling growth of the money stock through monetary base control is perfectly reasonable, sensible, and effective, provided that the interest rate outcome is then accepted as the inevitable consequence. In Thailand, however, the lower deposit rates, and eventually lower loan rates, implied by reserve requirements do not sit well with the need for monetary policy restraint and a dearth of domestic savings.

In a profit maximising banking system, the level of bank liabilities (deposits) and hence assets would be determined where the marginal cost of attracting an extra deposit unit was equal to the marginal revenue gained from employing that deposit. Reserve requirements on banks liabilities typically leave the marginal cost of funding unchanged, but reduce the marginal revenue from lending activities, since some proportion of the deposit mobilised has to be kept interest-free at the central bank.

THAILAND: CHART 9
INTEREST RATE



THAILAND: CHART 10
STOCKMARKET PERFORMANCE



In a scenario of rising reserve requirements, therefore, banks are deterred from actively bidding for deposits, causing deposit rates to decline. The private sector is encouraged to "dis-intermediate" out of bank deposits and seek higher returns elsewhere (notice that dis-intermediation of deposits represents a change within, and not a fall, in the money stock). At the same time, the private sector will attempt to lower its cost of borrowing through recourse to unregulated channels. The releases of liquidity which this provides to other parts of the financial system puts general downward pressure on yields. The process goes full circle when regulated lenders attempt to preserve market share by pricing loans more attractively. In Thailand, the extent of flows into higher yielding, non-bank, assets are not published although anecdotal evidence suggests that local mutual funds are substantial beneficiaries. What is observed, however, is the pressure for bank base rates to fall. Prime rates, shown in Chart 9 fell in May for the first time in this cycle.

Downward pressure on loan rates after a prolonged period of reserve requirement hikes implies some slackening in loan demand as well as the existence of excess liquidity within the financial sector as a whole. While a significant slackening of loan demand has yet to be corroborated by the loan growth numbers shown in Chart 2, it is worth noting that moral suasion forms a large, and effective, part of monetary policy in Thailand. Thus seasoned observers of the Thai monetary cycle can take some comfort that the fall in prime rates has probably come with the BoT's sanction, along with a view that loan growth is likely to continue its deceleration in the near future.

Stock Market Earnings and Domestic Savings

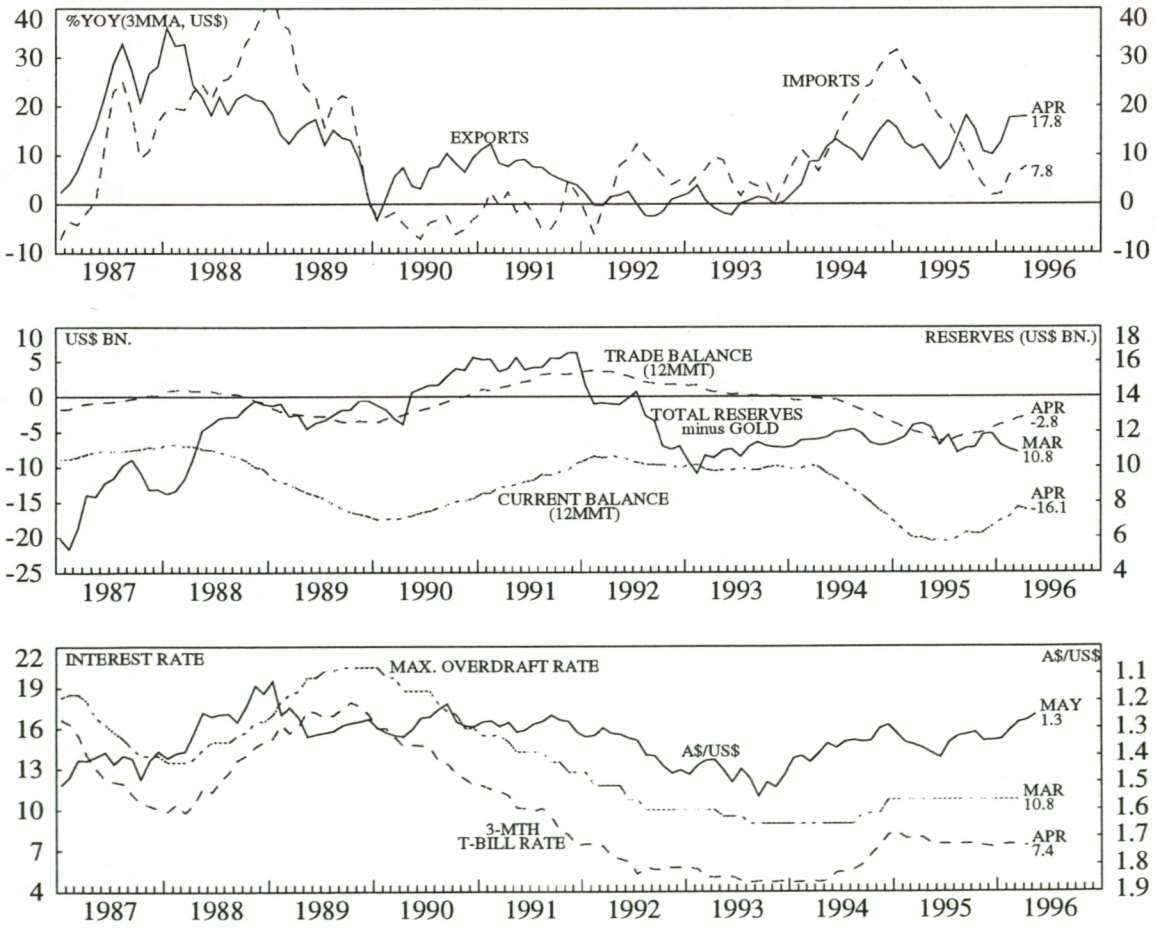
Political factors, poor earnings from a slowing economy, and the outlook for US interest rates have clouded progress of the equity market in 1996 (see Chart 10). The squeeze on financial sector earnings, triggered partly by BoT monetary policy tightening, has been reflected in the lacklustre performance of these stocks, which account for around 35% of the SET Index. Finance companies have been especially vulnerable, not least because they are reliant for funding on volatile and often expensive interbank markets. The foregoing discussion highlights the mobilisation domestic savings as the main long-term challenge for the financial sector. While a significant degree of "financial deepening" in Thailand has been visible over past few years (better branch access, more ATM machines) clearly much more needs to be achieved in order to minimise reliance on overseas savings. It is difficult at this juncture to see how such a transformation can be achieved swiftly, in the face of greater competition and potentially lower loan volume growth, without higher costs and lower earnings within the financial sector. Nevertheless, stock market progress, in the short-term will be dominated by cyclical issues which are likely to be taking on a much more positive tone later in 1996.

SUMMARY AND CONCLUSIONS: In this article we have considered the major reasons for relative robustness of Thailand's economic cycle and its resistance to official attempts to rein in growth. Two main factors are undermining BoT monetary policies: excess liquidity, and perverse effects arising from a prolonged period of rising bank reserve requirements. Both factors have combined to lower interest rates, which should continue to ease (gradually) over the remainder of 1996. Greater currency flexibility is to be encouraged as an important step towards eliminating excess liquidity. However, we have highlighted the dangers of implementing such reforms while the monetary and interest rate cycles in Thailand remain temporarily decoupled from those in nominal anchor countries: mainly the US. These cyclical divergences should becomes less obvious by 1997 Q2, and the BoT should not lose the opportunity to widen Baht fluctuation bands at that time. A move to float the Baht is ruled out because of the likely negative impact on exporters. Within the financial sector, the reliance on overseas saving is really reflecting a dearth of domestic savings which presents a challenge to both the BoT and domestic banks. The financial deepening necessary to rectify this imbalance will, in the long-run, mean higher costs and lower earnings for financial intermediaries. Nevertheless, progress of the beleaguered stock market will be dominated by cyclical issues, which are likely to be taking on a more positive tone later in 1996 -- especially if US interest rates fall once again in H2 .

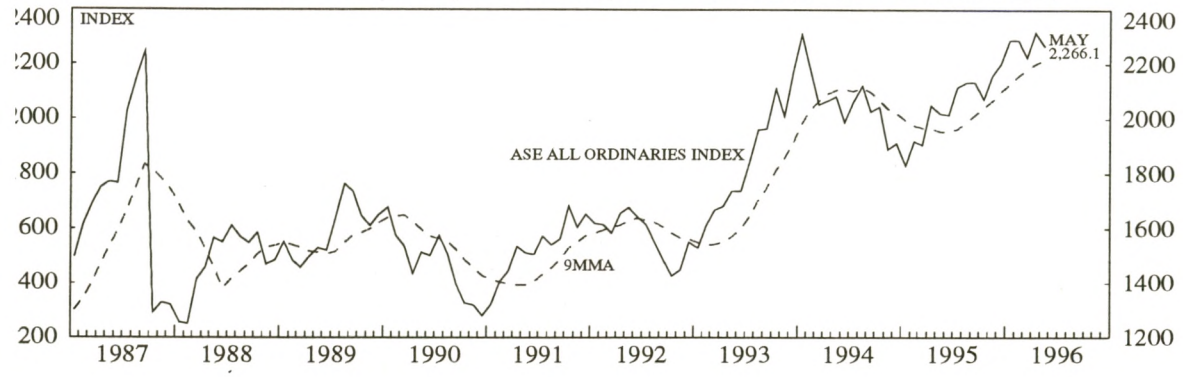
AUSTRALIA: MID-CYCLE PAUSE

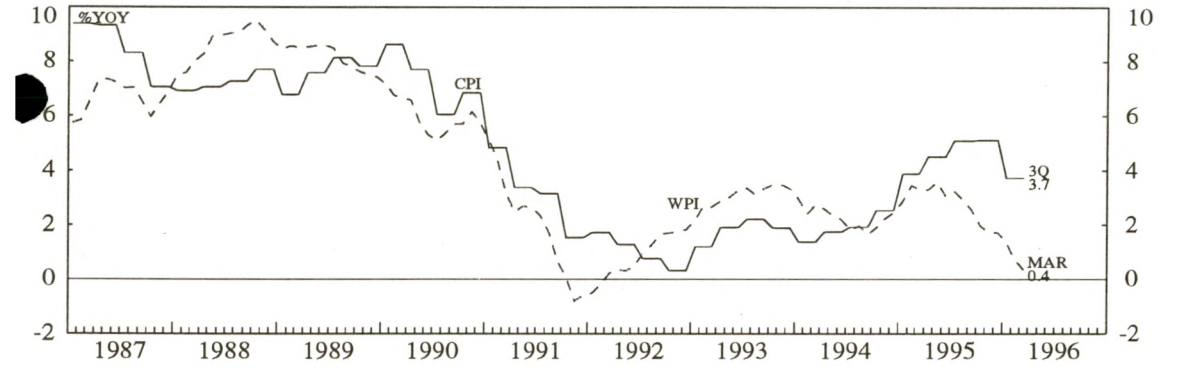
Although real GDP accelerated to 5.1% in the first quarter of 1996, this disguises mixed trends within the economy. During the course of 1995 the business sector slowed, with industrial production and capital investment on a weakening trend. The housing sector, which was the first area to weaken in 1994-95, has stabilised, but remains subdued. However, consumer expenditures and consumer sentiment remain surprisingly robust. Although the jump in interest rate sensitive expenditures may be dropping out of the headline CPI rate, the underlying rate (3.3% in Q1) remains on an upward trend. Measures of broad money and credit growth credit have started to reaccelerate. While underlying inflation pressures may abate in the near term, this year, a rise in the momentum of the economy in the year ahead will cause them to intensify. The RBA will probably delay further interest rate rises until more comprehensive signs of an upturn emerge or until the Fed in the US raises the Fed Funds rate. The current account and trade accounts have passed their worst for now and the A$/US$ can strengthen in line with further pockets of strength in Australian commodity prices. Bond and equity markets performed strongly in 1995 mostly in response to moves in their US counterparts. The Australian yield curve has flattened as the economy has reached a pause. However, the scope for further favourable bond market moves is more limited, and so additional gains in non-commodity related equities will likely be more difficult.

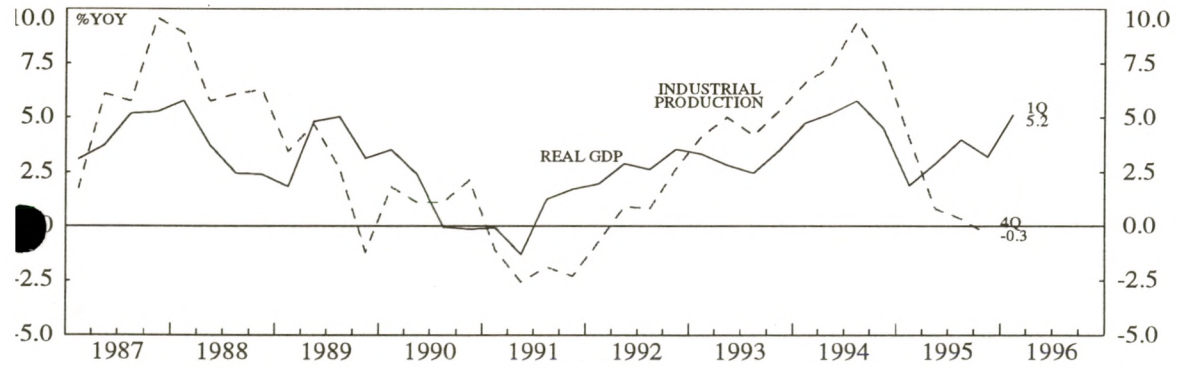
AUSTRALIA: MONEY MARKET AND BALANCE OF PAYMENTS

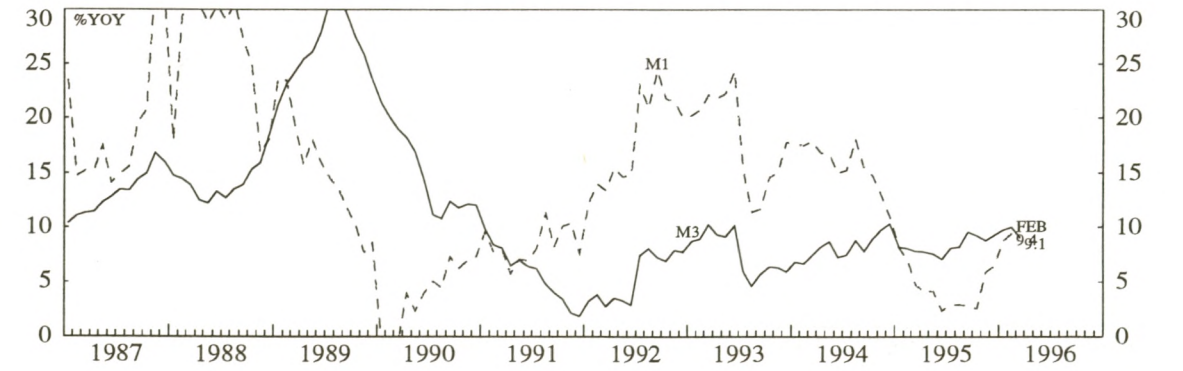


AUSTRALIA: MONEY, OUTPUT, GOODS AND ASSET PRICES





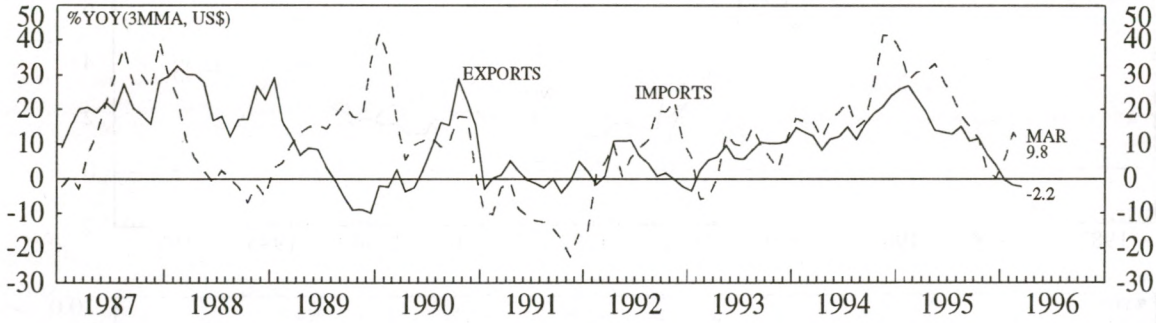


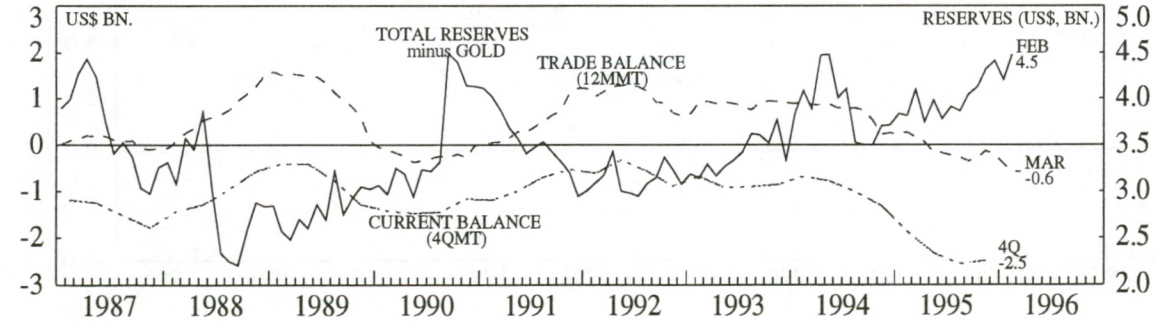


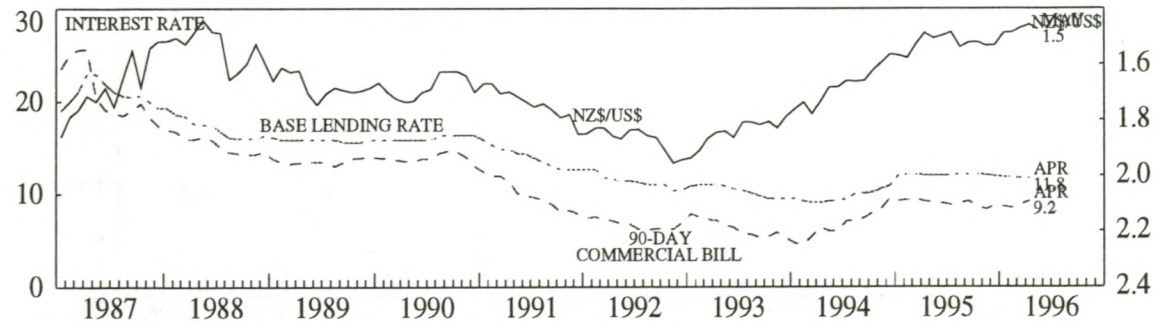
NEW ZEALAND: CLOSE TO THE PEAK OF INTEREST RATES

The Reserve Bank's frequently stated desire for continued tight monetary conditions has been reflected in a continual rise in the NZ$ Trade Weighted Index (TWI) and in short-term interest rates (3-month bank bills). Real GDP and manufacturing production have already been hit severely by this tight set of monetary conditions. Since early February increased monetary tightness has been reflected less in the exchange rate (TWI has been stable around 64-66) and much more in short-term interest rates, which have risen from 8.5% to 10% in nominal terms, i.e. an excessively high 8% real short-term interest rate. Although the monetary aggregates are still growing strongly and Auckland's real-estate boom is still ongoing, it is only a matter of time (we think months rather than years) before we see signs of weakening in these few areas of Reserve Bank anti-inflationary concern. Once this happens, the Reserve Bank will quickly endorse lower short-term interest rates and a less rapidly appreciating TWI, unless it wants to risk breaching the lower bound of the 0-2% inflation target.

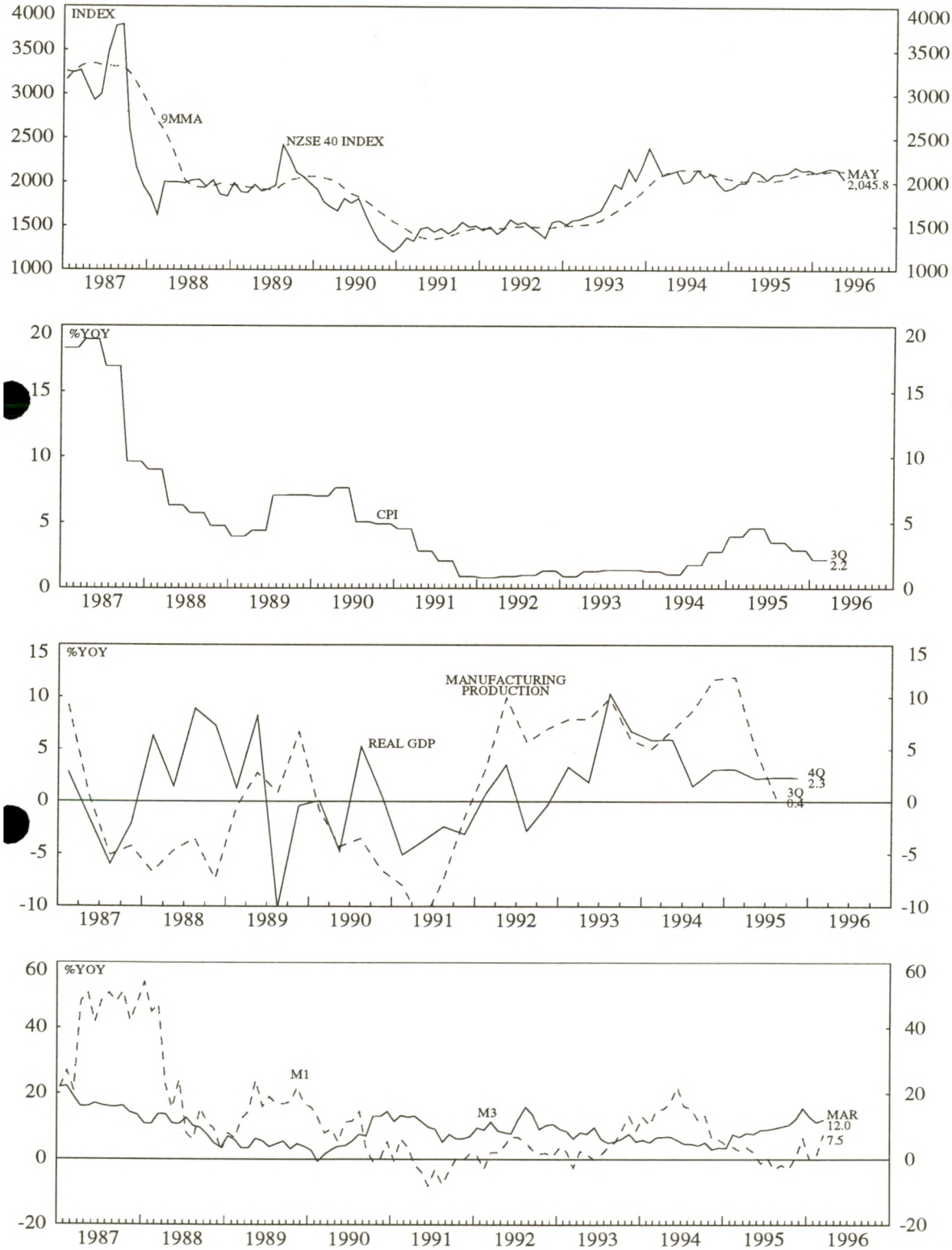
NEW ZEALAND: MONEY MARKET AND BALANCE OF PAYMENTS

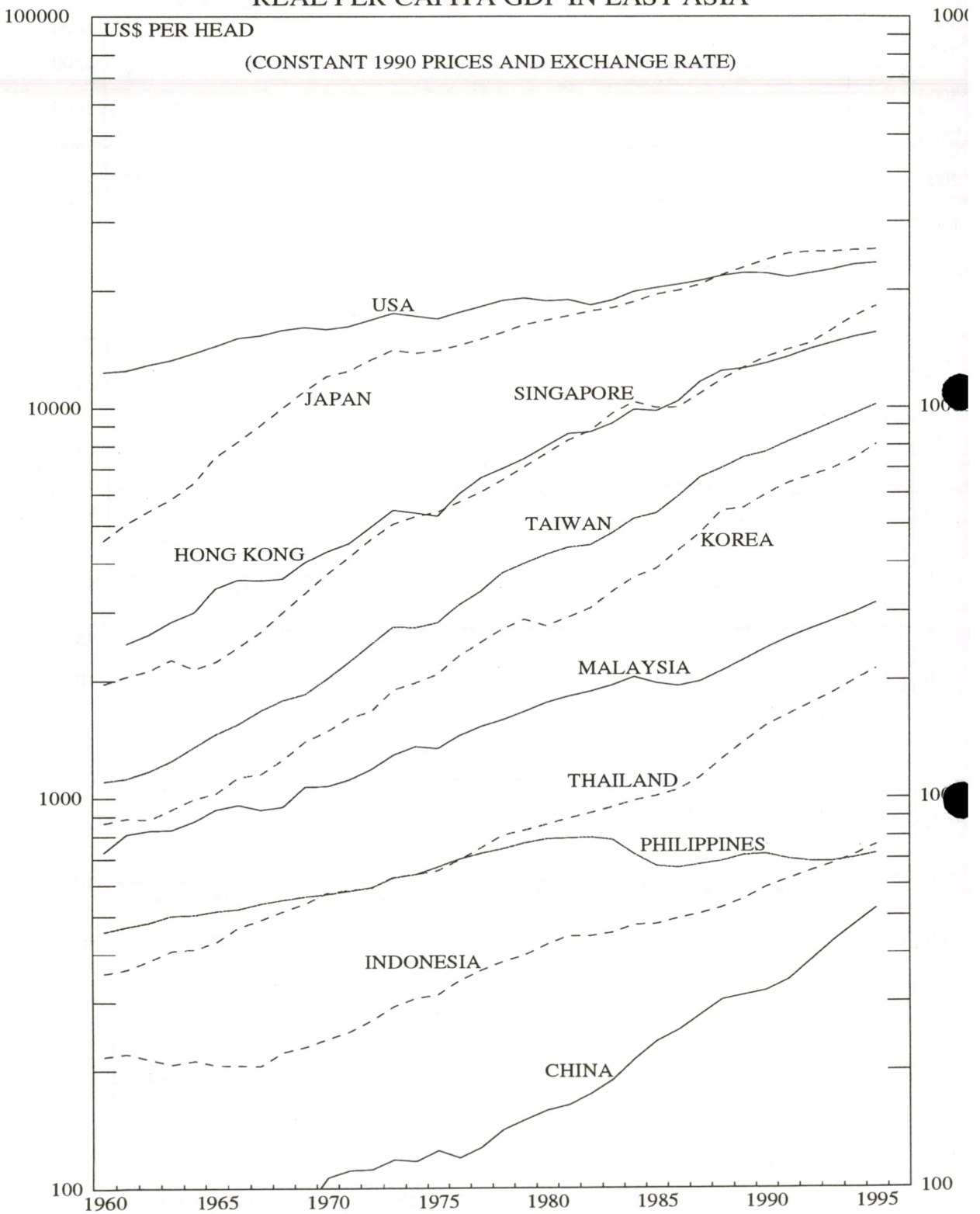






NEW ZEALAND: MONEY, OUTPUT, GOODS AND ASSET PRICES




REAL PER CAPITA GDP IN EAST ASIA
US$ PER HEAD
(CONSTANT 1990 PRICES AND EXCHANGE RATE)
100000
10000
1000
100
USA
JAPAN
SINGAPORE
HONG KONG
TAIWAN
KOREA
MALAYSIA
THAILAND
PHILIPPINES
INDONESIA
CHINA
1960
1965
1970
1975
1980
1985
1990
1995

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INDIA
MONEY TO EXPAND, ECONOMY TO PAUSE

Introduction

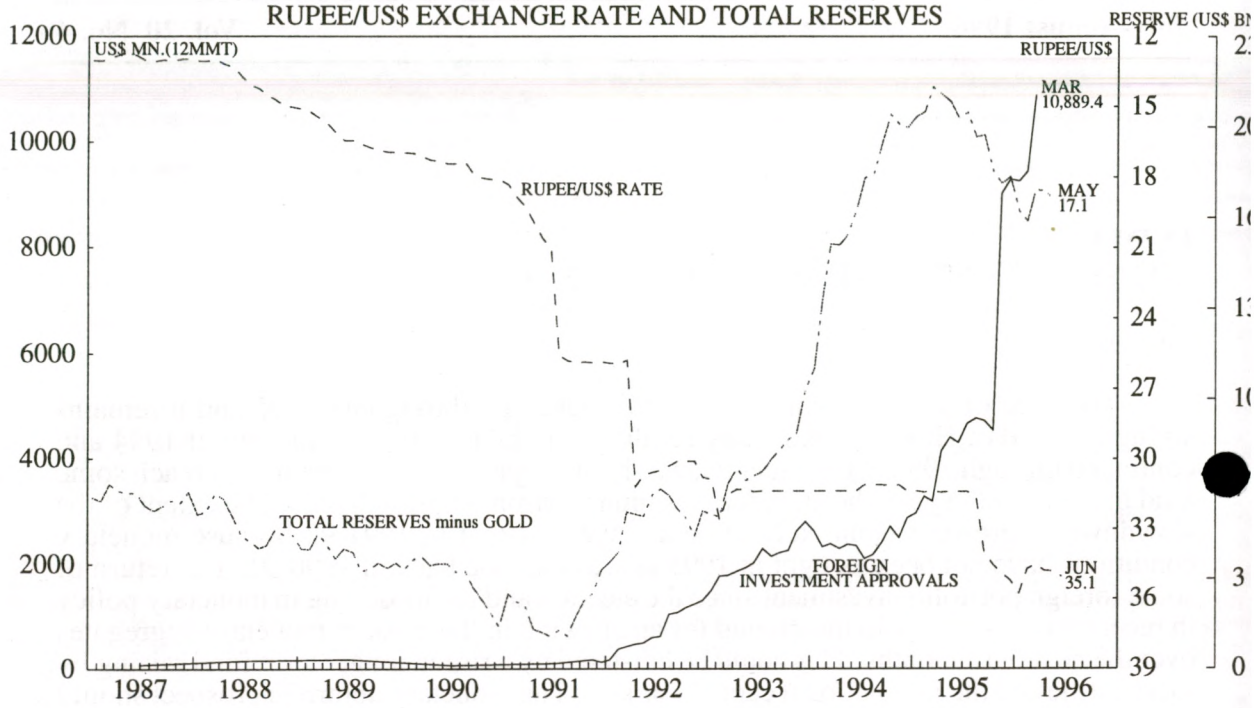
The pace of real economic activity has picked up throughout 1995 and it remains strong to this day. However, monetary conditions tightened towards the end of 1994 and continued through 1995. Consequently, we should expect the real economy to reach some kind of pause in the year ahead, before resuming a stronger growth path. The extent of the slowdown in prospect is unlikely to be as severe as that in 1991-92 because monetary conditions have not been as tight in 1995 as was the case back in 1990-91. The return of some foreign portfolio investment since the election and the loosening in monetary policy in recent months have laid the ground for an upswing in the broader monetary aggregates over the next 6-12 months. This could be bolstered by a rise in longer term fund raising by local entities on the international capital markets. The monetary upturn in prospect should support equity gains in the year ahead -- after the difficult year in 1995 -- and prepare the ground for a reacceleration in economic activity later in 1997.

In the recent economic boom, various supply-side bottlenecks have emerged across the country, especially in the power sector. Further ahead, the government may introduce extra incentives to attract greater foreign participation in this area. However, at present energy tariffs are rising sharply. This, along with strong domestic demand and the effect of the recent Rs/USD depreciation may cause CPI inflation to jump up in the coming months. However, accelerating inflation is unlikely to become a more persistent concern until later in 1997 after the economy has rebounded. The first part of this article reviews the recent changes in monetary conditions before moving on to the implications for the real economy and the external accounts.

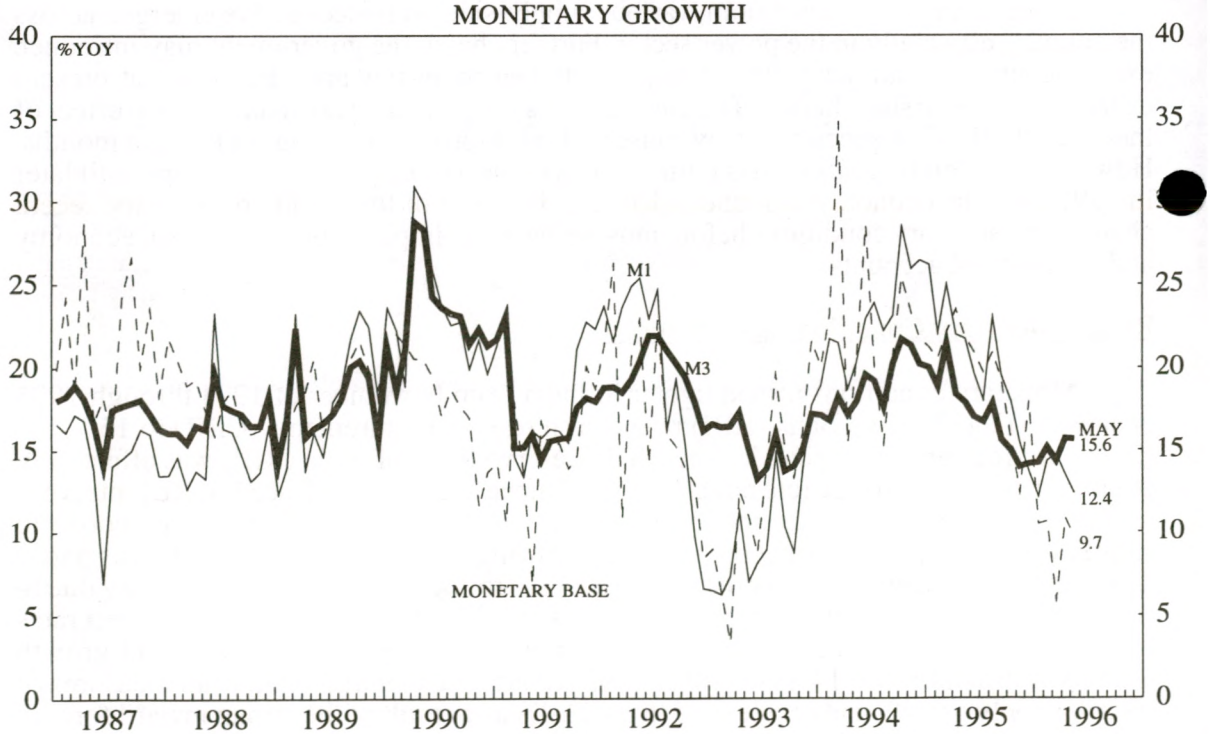
Recent Monetary Conditions and Prospects

Monetary conditions turned tighter in India from November of 1994 through 1995 because (1) the Reserve Bank (RBI) raised cash reserve requirements (CRR) to 15% and (2) inward foreign investment declined. The Reserve Bank of India (RBI) was effectively operating a fixed exchange rate policy with the Rupee/USD rate held at 31.4. RBI intervention at this parity led to a decline in its stock of foreign exchange reserves as portfolio capital withdrew and the extent of external borrowing declined (Chart 1). This was partly due to growing uncertainty over the outcome of the forthcoming election and partly due to the lagged effects of the tightening in US monetary policy during 1994. Local interest rates rose and there was a deceleration in all the indicators of monetary growth. M3 growth slowed by around 8% to 14%y-o-y over 1995 (Chart 2). Up until that time, all measures of money supply growth had accelerated to over 20% as a result of the strong inward foreign investment over 1993-94.

INDIA: CHART 1
INDIA: FOREIGN INVESTMENT APPROVED,
RUPEE/US$ EXCHANGE RATE AND TOTAL RESERVES



INDIA: CHART 2
MONETARY GROWTH



This decline in monetary growth brought about a liquidity squeeze in all areas of banks balance sheets and cut short the opportunities for gain on securities investments in 1995. The easy monetary conditions of 1993-94 had generated strong demand for credit and this is supported by the upswing in commercial bank credit to the private sector over most of 1995. However, towards the end of 1995 the tighter monetary conditions resulted in a slowdown in bank credit to the private sector which has continued to the present day (Chart 3).

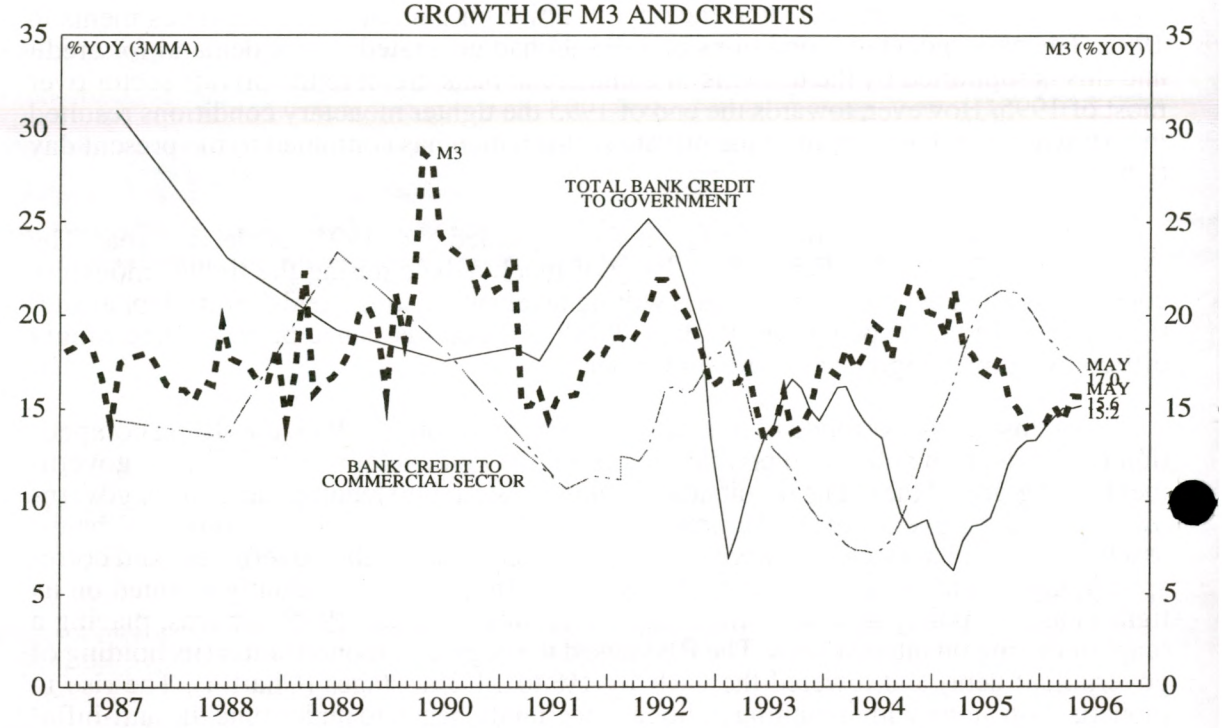
The public sector demand for credit also expanded over 1995, an election year. The expansion in the fiscal deficit was an issue of much debate during the tighter monetary conditions. The government found less willing takers at existing yields for its debt at auctions. Financing its expenditures through T-bill and bond issuance became increasingly difficult without nudging up rates a bit further.

Against the background of tighter monetary conditions in 1995, the strong competition for funds from public and private sectors led to two developments. First, the government strong-armed the (State dominated) banking system into lending more to the government to take on even more government bonds. The composition of commercial banks assets began to change as they were persuaded to lend more to the government and correspondingly less to the private sector (Chart 3). Second, the RBI gradually relented on its tight monetary policy and eased monetary conditions from late 1995 onwards, placing a 'cap' or ceiling on interest rates. The RBI raised the degree of monetisation (its holding of government debt) and lowered the CRR by 1% to 14% in stages (Chart 4). The rise in monetisation along with mounting political uncertainty began to undermine the anti-inflationary policy and therefore the existing exchange rate parity -- fixed at 31.4Rs/USD. Despite this reversal in monetary policy conditions credit growth to the private sector has slowed over the last six months.

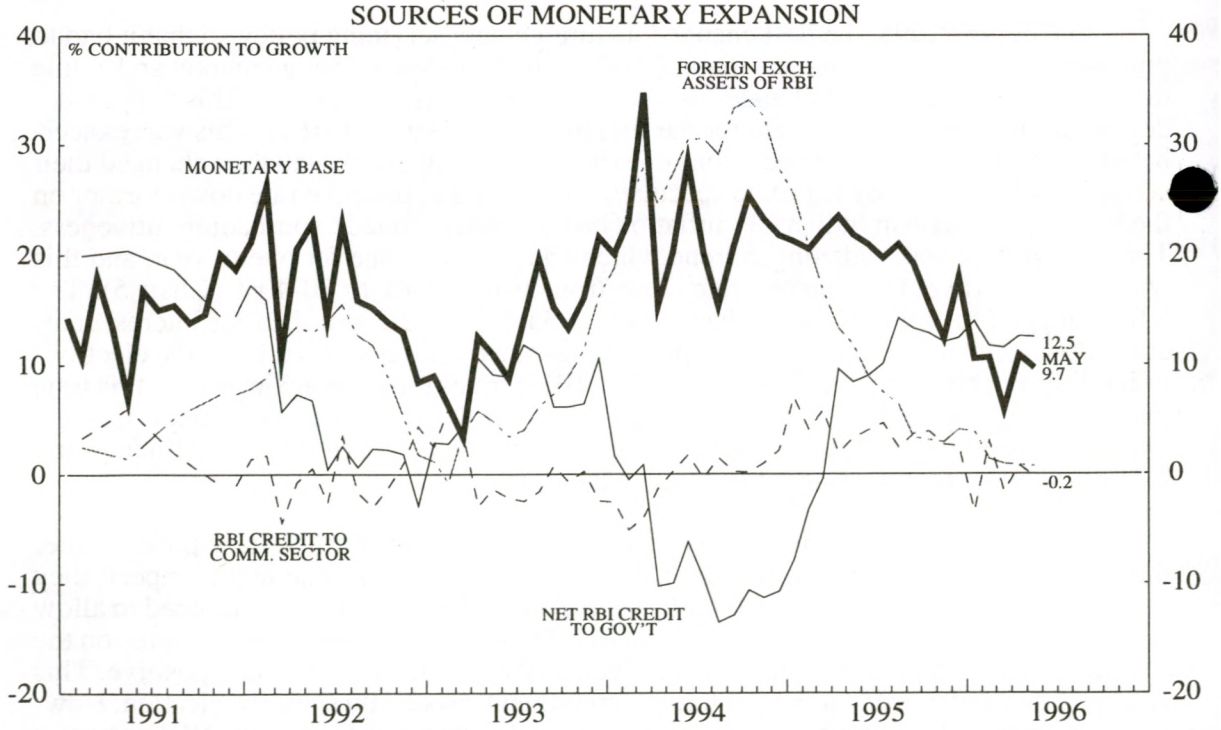
In Oct/Nov 1995, the RBI changed its foreign debt servicing policy so that it had to purchase the US$s from the open market. Being a thin foreign exchange market and a time during which its foreign exchange reserves had been declining anyway, this triggered a depreciation in the exchange rate for the first time since 1993 (Chart 1). This was exacerbated by (1) the change in expectations of exporters and importers who then changed their conversion habits and by (2) some speculators who tried to push the rate down further on the basis that the rise in Indian CPI inflation had seriously eroded export competitiveness. The trade deficit was widening, a trend which had been in place for over a year, and this was not supportive. Call interest rates rose from around 10% to 30-40% (Chart 5). The RBI managed to stabilise the exchange rate at 35-36Rs/USD and then let interest rates come down. However, the downward pressure resumed (closer to the time of the election) in Jan/Feb, pushing it to over 38Rs/USD. The RBI let rates move up again, except this time they moved the 'goalposts' by placing temporary controls on conversion for importers and exporters. This stopped the Rs/USD slippage. After the election (in May) confidence and foreign capital returned bringing stability to the Rupee.

The RBI state that their primary aim is to pursue an anti-inflationary policy rather than commit rigidly to any particular exchange rate. However as one might expect, they would prefer also to preside over a stable Rupee/USD, although they are prepared to allow some depreciation to maintain competitiveness. The balance of payments pressures on the Rupee have switched from being negative (before the depreciation) to more positive. This is mainly due to the stronger inward foreign investment, especially since the election. However longer term, the Rupee will continue to slip and slide for as long as the RBI operate a

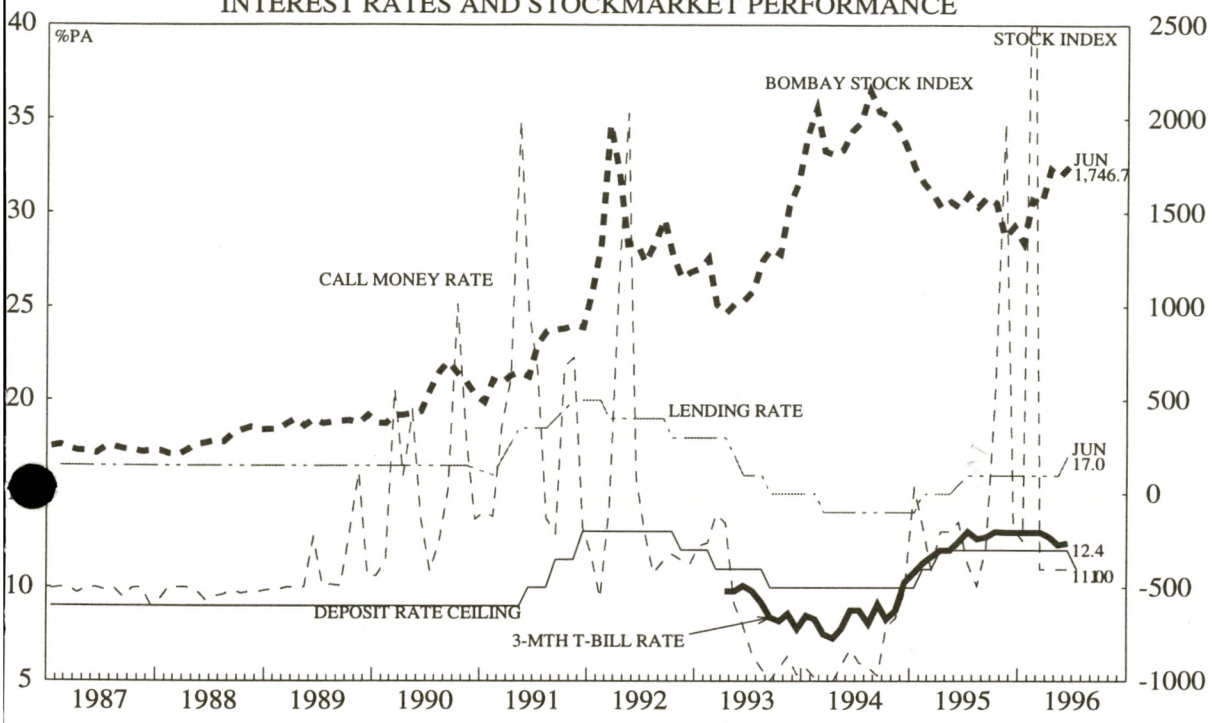
INDIA: CHART 3
GROWTH OF M3 AND CREDITS



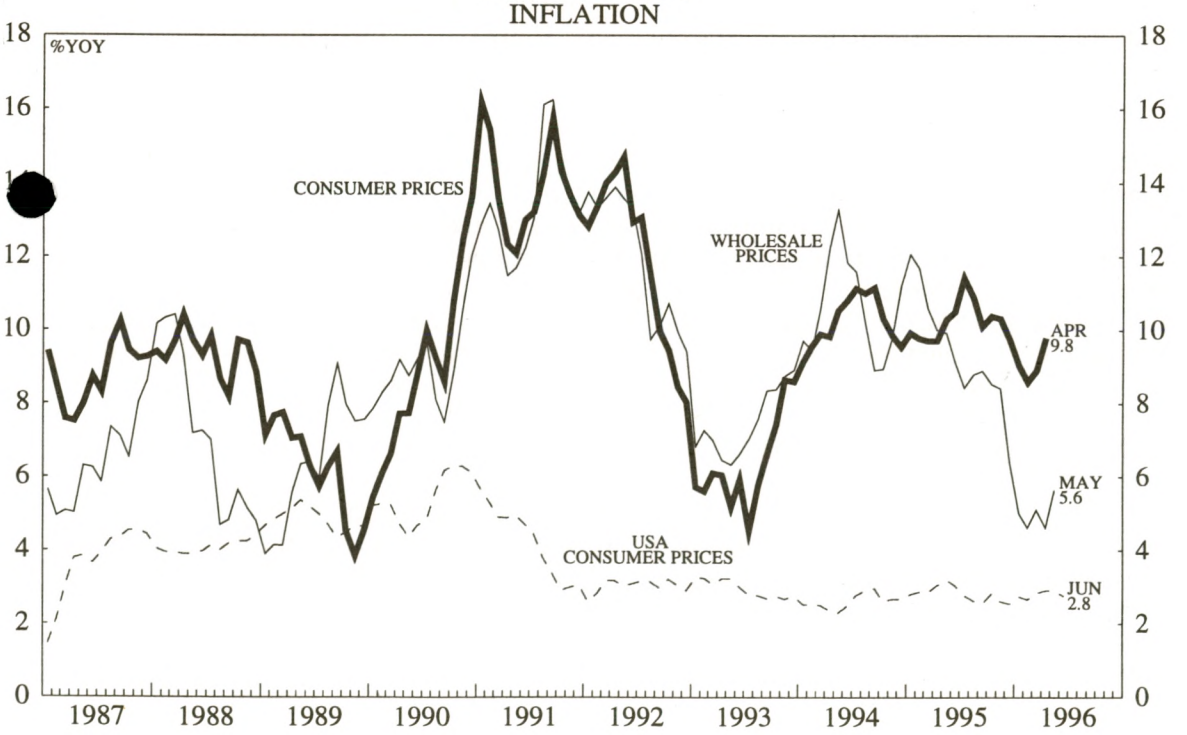
INDIA: CHART 4
SOURCES OF MONETARY EXPANSION



INDIA: CHART 5
INTEREST RATES AND STOCKMARKET PERFORMANCE



INDIA: CHART 6
INFLATION



monetary policy which generates a rate of inflation greater than that in its competitors. Currently wholesale prices in India are growing at a rate almost double that in the US while Indian consumer price rises outstrip those in the US by over 3 times (Chart 6).

The administration's preference to manage a relatively stable exchange rate for most of the time while sometimes pursuing inconsistent domestic monetary policies is bound to lead to a weaker exchange rate at some stage. The recent episode of attempting to support an exchange rate parity while monetising government debt and lowering reserve requirements is a case in point. The RBI even imposed extra restrictions on various participants of the foreign exchange rate market, to help restore exchange rate stability and bring down local interest rates. However, this was too late. In any event, restrictions on foreign exchange conversion can only delay the underlying exchange rate pressures from feeding through, not negate them.

In the April Credit Plan the RBI cut the CRR by 1% to 13%. It also introduced a host of minor changes designed to increase the financial system's absorption of government debt. Since the election, in May, there has been a reflux of inward foreign portfolio investment and this alone has eased monetary conditions. This has supported the currency and led to an easing of interest rates. This extra support to the currency has made room for the authorities to ease monetary policy yet again. In late June, the RBI announced a further set of measures. These included: (1) a further cut in the CRR to 12%, and (2) minor deregulation of interest rates, although they have not changed the fundamental primitiveness of the existing money markets.

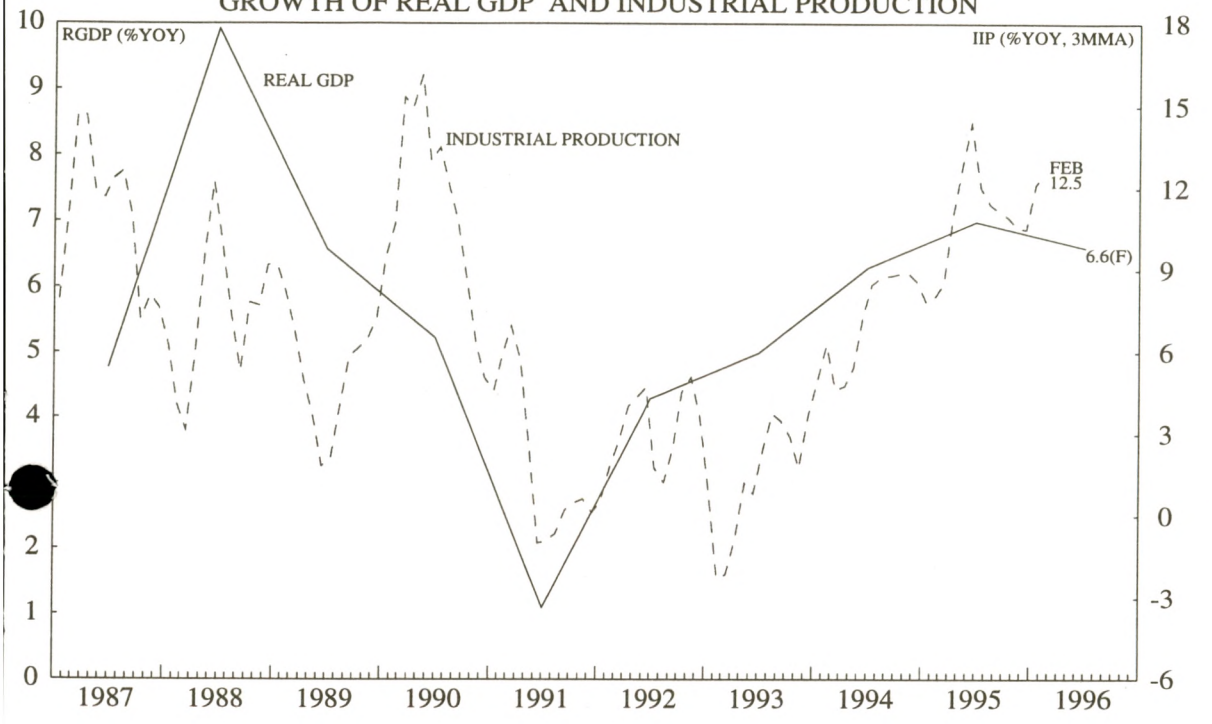
A recovery in foreign equity investment, external lending and the reserve requirement cuts have brought down local interest rates. 3 month T-bill rates have declined from around 10% just after the election to 8-8.5% today, while the call rate has collapsed to low single digits. If these conditions persist, M3 growth will reaccelerate later in 1996 and conditions will improve in the securities markets. There will be more longer term liquidity support for future gains in the equity market.

In these more stimulative monetary conditions the extent of RBI monetisation should decline. In addition, the government will probably bring forward as much of its debt funding as possible, to take advantage of the lower interest rates and easier liquidity conditions. Further reductions in reserve requirements can be expected as the banking sector is gradually deregulated. However, aside from this, the recent cuts in reserve requirements have served the dual purpose of reducing the cost of government borrowing and limiting the forthcoming downturn in the economy. For the time being, the RBI is likely to wait and see how the recent monetary stimulation affects the economy. As the economy slows there may be additional CRR cuts in the pipeline, especially if it slows sharply.

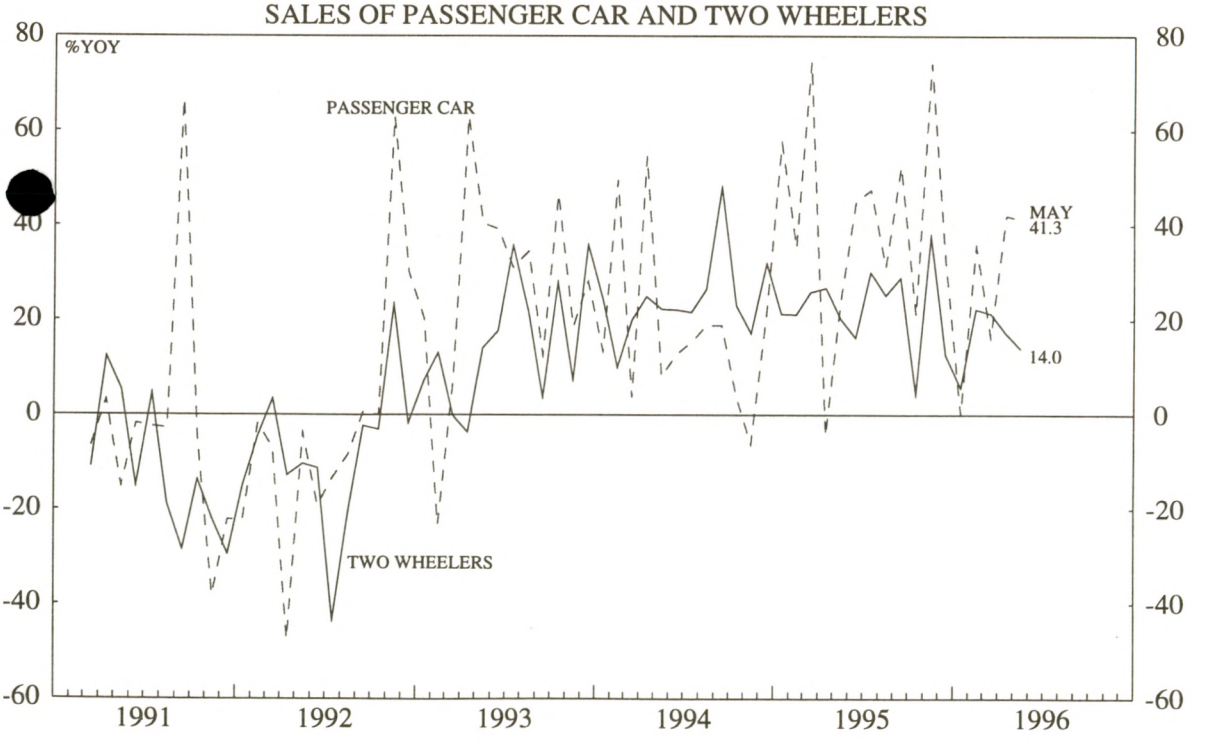
The Real Economy and Inflation

Notwithstanding the tighter credit conditions in 1995, real economic activity boomed. both in agricultural and manufacturing areas. The demand for passenger cars, two wheelers and various intermediate goods has been very buoyant. This trend has persisted to the first quarter of 1996 (Charts 7 and 8). However, there has been a glut in some goods such as man-made fibres, drugs and chemicals. Growth in industrial production has accelerated over the course of 1994-95, but this year it appears to be stabilising around low double digits. The pace of real economic activity is likely to slow temporarily in the near-term in response to the tighter monetary policy in 1995. The monetary upturn in prospect in the second half of this year should ensure that the economy recovers in 1997.

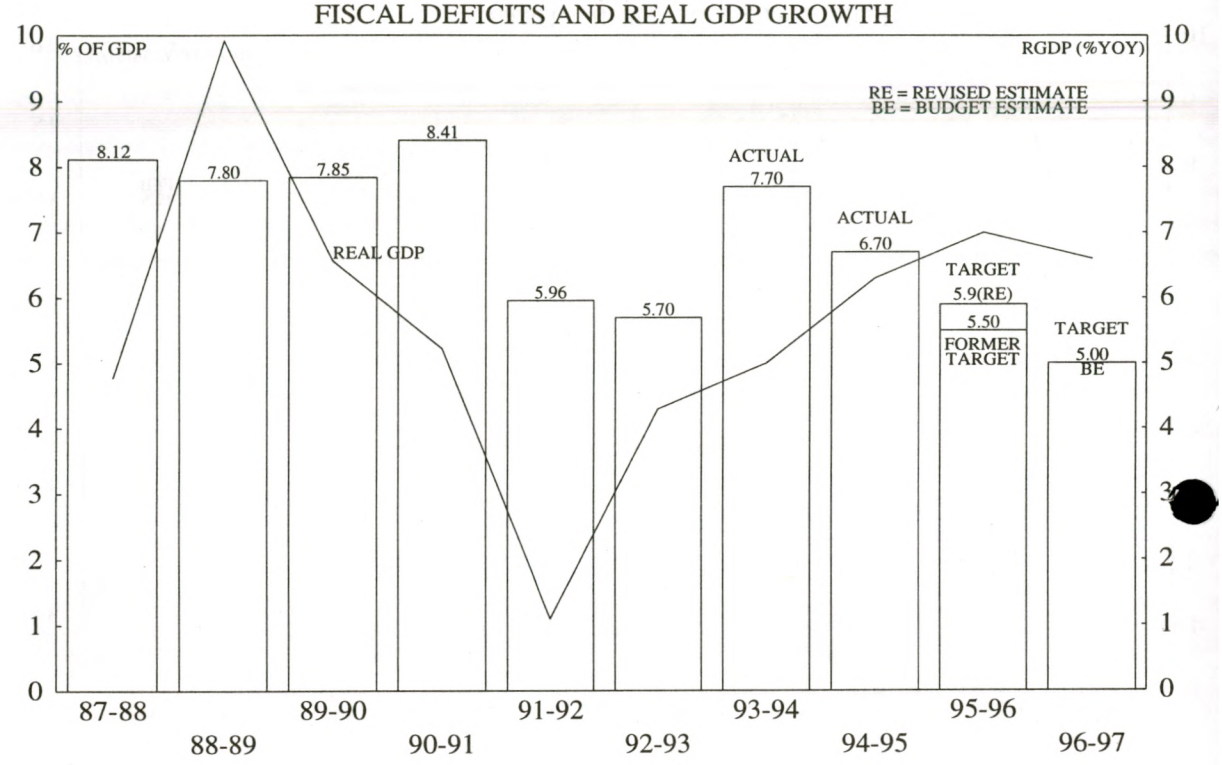
INDIA: CHART 7
GROWTH OF REAL GDP AND INDUSTRIAL PRODUCTION



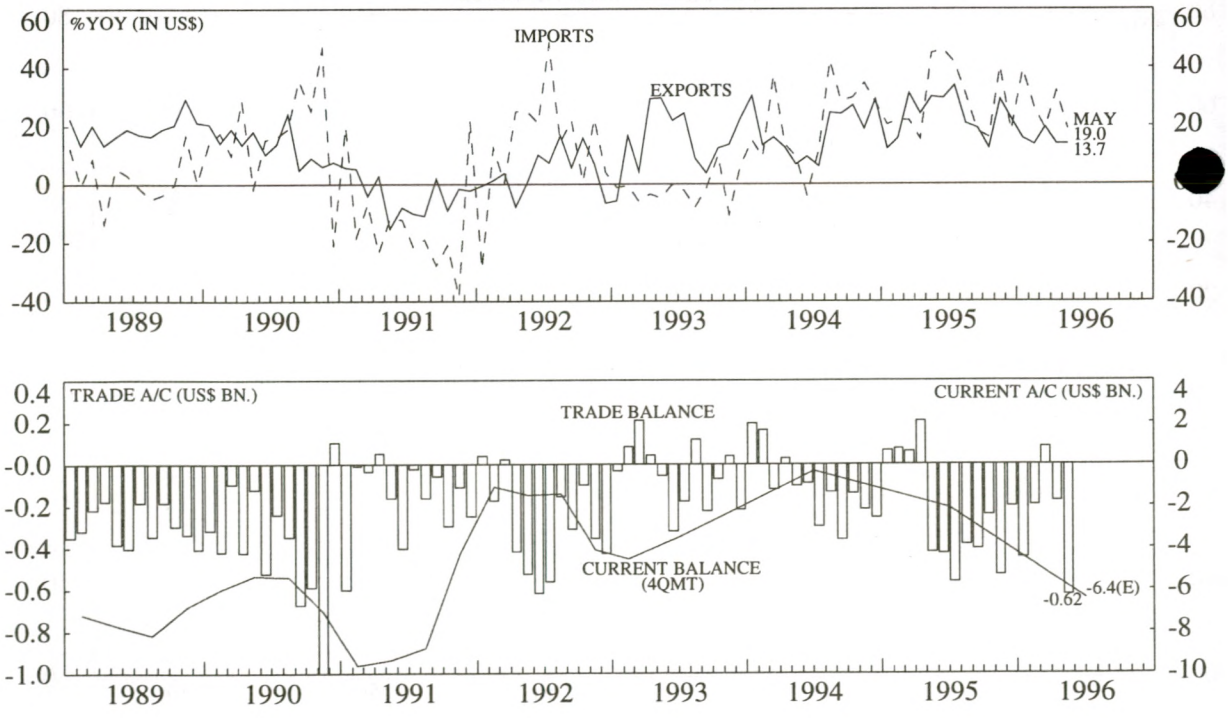
INDIA: CHART 8
SALES OF PASSENGER CAR AND TWO WHEELERS



INDIA: CHART 9
FISCAL DEFICITS AND REAL GDP GROWTH



INDIA: CHART 10
TRADE PERFORMANCE



In the agriculture sector, India has been blessed with good monsoons for the past 8-9 years. The existence of generous subsidies and a system of price support has meant that the government has maintained substantial stocks of grain over the past few years. Evidence to date suggests that this year the monsoons have been normal, so once again we can expect the government to continue to record large surpluses of grains. In the year leading up to the recent election, the government delayed the price increases in some goods and suppressed those in others. The prices of rice and grains were no exception and remained stable through 1995. However, now that the election is out of the way the government is raising the minimum support price for grains by 10-15%.

The strength in the economy accounts for much of the well-publicised strains on infrastructure, especially power. The more industrialised regions appear to be starving the less developed ones of their power needs. Some areas are about to or have already raised energy tariffs, as in: Orissa, Maharashtra, Karnataka and Andra Pradesh. Temporary power-cuts are becoming more frequent, but the situation is not as bad as that in the Philippines a few years ago. Price hikes are also occurring in other areas, for example in the coal industry. The government is slowly liberalising coal prices on various grades. In addition, Coal India Ltd has revised its prices to various iron and steel companies such as SAIL and TISCO in line with stronger demand. In the meantime, coal imports have risen sharply.

Over the last 12-18 months, the inflation rate of the WPI, and to a lesser extent of the CPI, came down by more than would be implied by the upswing in general demand conditions. In the months ahead we may witness an element of 'catch-up' across some of the administered prices, which may feed through to the CPI and knock it back up into double digit territory again (Chart 6). This would be augmented by the recent strength in domestic demand and by the higher cost of some imports as a result of the depreciation at the start of the year. However, despite the upspikes in CPI inflation ahead, the downturn in domestic demand will prevent a trend of higher CPI inflation from developing and becoming a persistent concern until late in 1997.

After the initial improvements made in reducing the fiscal deficit over the 1990-92 period it has proved difficult for the governments to continue to make good progress here (Chart 9). In the fiscal year which led to the recent election, the government could not adhere to its spending plans and proposed cuts in subsidies over 1995-96. Consequently, the fiscal deficit expanded to an equivalent of 5.9% of GDP, compared with a target of 5.5%. In the forthcoming fiscal year (1996-97) the current coalition government aim to reduce the fiscal deficit to an equivalent of 5% of GDP. They are intending to see some of this reduction arise from improved corporate tax revenues.

External Accounts

In recent months export growth has slowed while that in imports has remained relatively strong, in line with the strength in domestic demand. These trends have brought about a deterioration in the trade deficit and this has led to a widening in the current account deficit (Chart 10). Trends in the trade balance have not been particularly large or noteworthy since the balance of payments crisis in 1990. To some extent this can be explained by the relatively closed nature of the current account and the subdued pace of economic growth up until 1993-94. The finance minister announced full convertibility of the Rupee on all current account transactions in March of 1995.

Over the last two to three years there has been a substantial amount of inward foreign direct investment and reduction in import barriers. This should begin to be reflected in persistently stronger import growth and therefore a wider trade deficit in the year ahead. However, the pause in economic activity ahead may provide temporary respite. In addition, the trade deficit and current account deficits are still relatively small as a percentage of GDP, equivalent to around 1.1% and 1.8% respectively in 1995.

SUMMARY AND CONCLUSIONS: In the second half of 1996, the real economy will reach a pause although not slow significantly in response to the tighter monetary conditions in 1995. Monetary policy has eased in recent months as foreign investment has returned and as the RBI has reduced reserve requirements. This monetary expansion will support equity gains in the year ahead. The easier monetary policy today should lead to an upswing in broad monetary growth which, in turn would lay the ground for a reacceleration in the economy from mid-1997 onward. While the currency is fragile given the easier monetary stance, it is well supported by foreign capital and may not come under more intense weakening pressure until after the economy recovers from its pause and the CPI rebounds more persistently. However in the immediate months ahead the CPI rate of inflation may jump up and this could introduce temporary uncertainty into the future path of the RS/USD.

MALAYSIA
INTEREST RATES APPROACH POLITICAL BITING POINT

Introduction

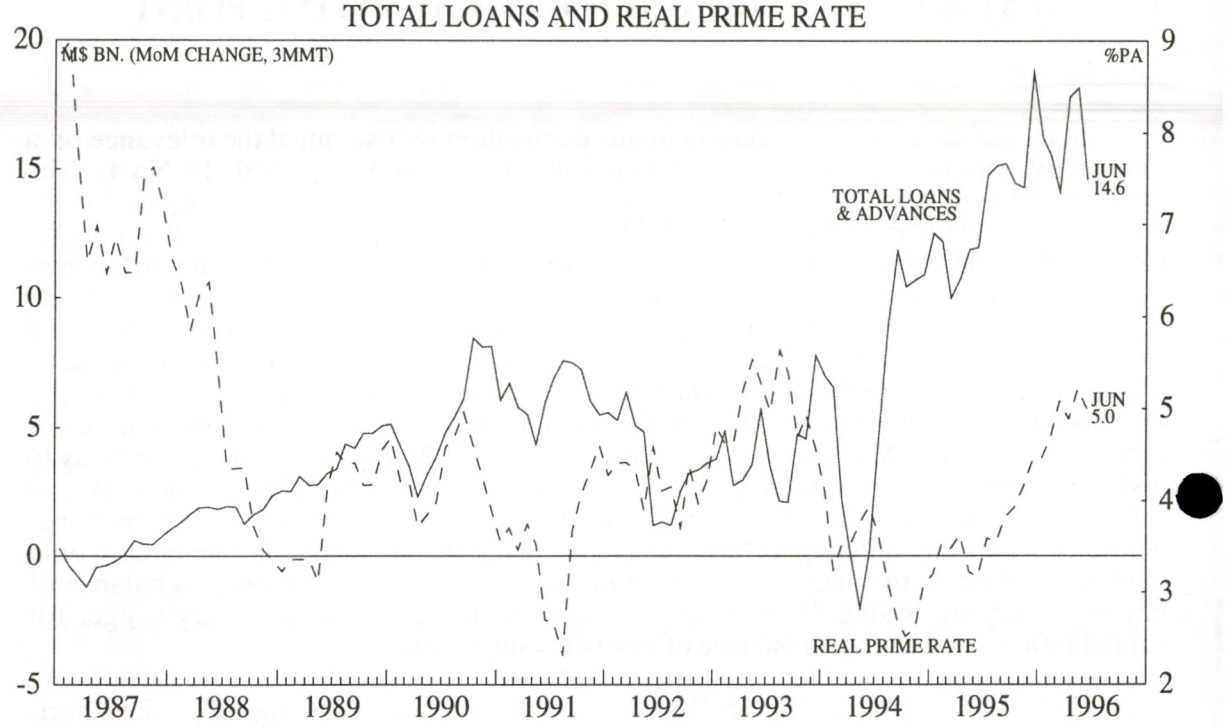
In an earlier review of Malaysia in this publication we examined the relevance of a "monetary approach to the balance of payments" (see AMM 1995 Vol. 19 No.4). The framework has proved consistently accurate in forecasting balance of payments and monetary policy trends in Malaysia over the 1980s and, recent history suggests that conclusions of the model remain robust. The "monetary approach" essentially treats balance of payments flows as simply being determined by imbalances between the money stock and money demand. Other things being equal, any discrepancy between money supply and money demand is eliminated through running balance of payments surpluses or deficits, which in themselves are the adjustment mechanism by which these surpluses or deficits are eliminated. In our July-August 1995 review (op. cit), we showed that the legacy of excess money supply which Malaysia had accumulated since 1992, was likely to be giving way to a sizeable upward shift in money demand; owing to the pace of economic activity and inflation. The article argued that since Bank Negara Malaysia (BNM), the central bank, would be increasing unlikely to "accommodate" rising money demand. The latter would then be satisfied, at the margin, through attracting overseas capital: running a balance of payments surplus. Rising domestic interest rates would act as the necessary trigger for capital inflows and attendant balance of payments surpluses .

Over 1996 so far, monetary policy has "turned the corner", driving Malaysian short-term interest rates steadily above global levels. Growth in foreign currency reserves suggests that higher Malaysian interest rates have been successful at attracting large volumes of capital from overseas which, in turn, have been a source of support for the Ringgit and the wide trade deficit. Finally, inflation, as a lagging indicator of economic activity, has picked up into 1996, even on the government's own CPI index. In theory, the temporary improvement in the current account deficit seen over 1996H1 is also consistent with this monetary framework, to the extent that rising real interest rates may temporarily raise the level of savings. However, this would presume a fairly strong and immediate relationship between rising real interest rates and aggregate demand in Malaysia. In this article we show that such a relationship is likely to be weak in Malaysia, unless nominal interest rates are driven to, and maintained at, historically high levels for some considerable time. This implies that BNM's current approach of direct money supply control, for instance through raising reserve requirements, is likely to prove more efficient, politically acceptable, and effective as a means for restraining aggregate demand. The methodology used in this article borrows heavily from earlier work in this publication (see AMM 1979 Vol. 3, No.5) which looked at the interest rate adjustment mechanism in Hong Kong.

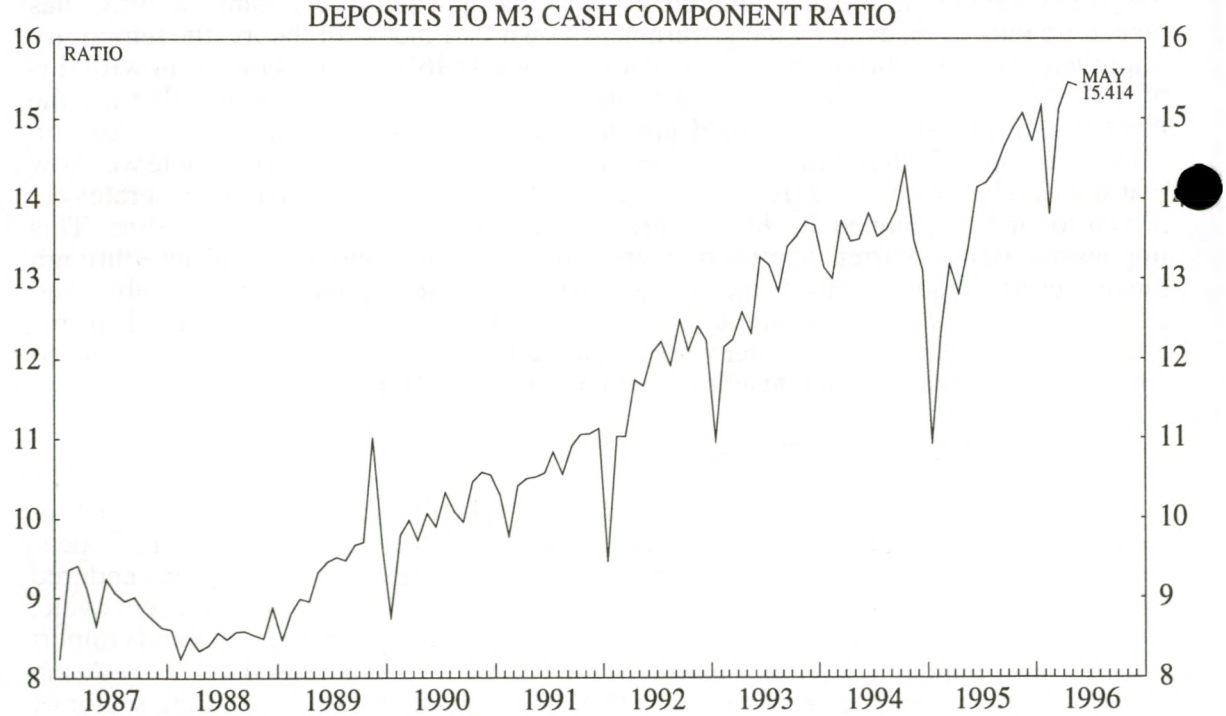
Capital Flows Diminish Interest Rate Sensitivity

It is worth observing that the protracted nature of credit cycles in certain Asian countries, provides anecdotal support for the notion that aggregate demand, in these small open-economies, is relatively insensitive to interest rates. Thailand, for instance has endured historically high interest rates for a prolonged period over the course of the current cycle, although the response of domestic demand (proxied, for example, by capital goods import growth) has been negligible until recently. The common problem faced by many Asian economies, with open capital accounts, is that the marginal cost to the banking sector of acquiring reserve assets -- the basis for credit expansion -- is not determined by domestic

MALAYSIA: CHART 1
TOTAL LOANS AND REAL PRIME RATE



MALAYSIA: CHART 2
DEPOSITS TO M3 CASH COMPONENT RATIO



interest rates, but by the cost of borrowing from overseas. Not only are overseas interest rates typically much lower, but relatively fixed exchange rates in Asia remove one element of risk from overseas borrowings. In practice therefore, domestic interest rates are ineffective at reducing credit volume expansion in Asia, because banks' reserve assets are insensitive at the margin to domestic interest rates.

The Malaysian Case

In general, a rise in interest rates is thought to affect aggregate demand through raising the cost of credit to the private sector and reducing private sector income. The transmission mechanism in this scenario works through a diminution in the demand for credit, while money supply growth is assumed to adjust passively downwards as banks bid less aggressively for deposits. While a full analysis of the impact of real interest rate rises on the demand for credit requires more complex models of private sector portfolio behaviour, Chart 1 shows that the links may be tenuous. It is likely that at least some of the acceleration in new loan activity over 1994 and 1995 was due to a period of unusually low real interest rates over 1994 and 1995H1, although similar behaviour is not observed in 1991. Neither does it appear new loan growth responded decisively to the sharp rise in real prime interest rates over 1993.

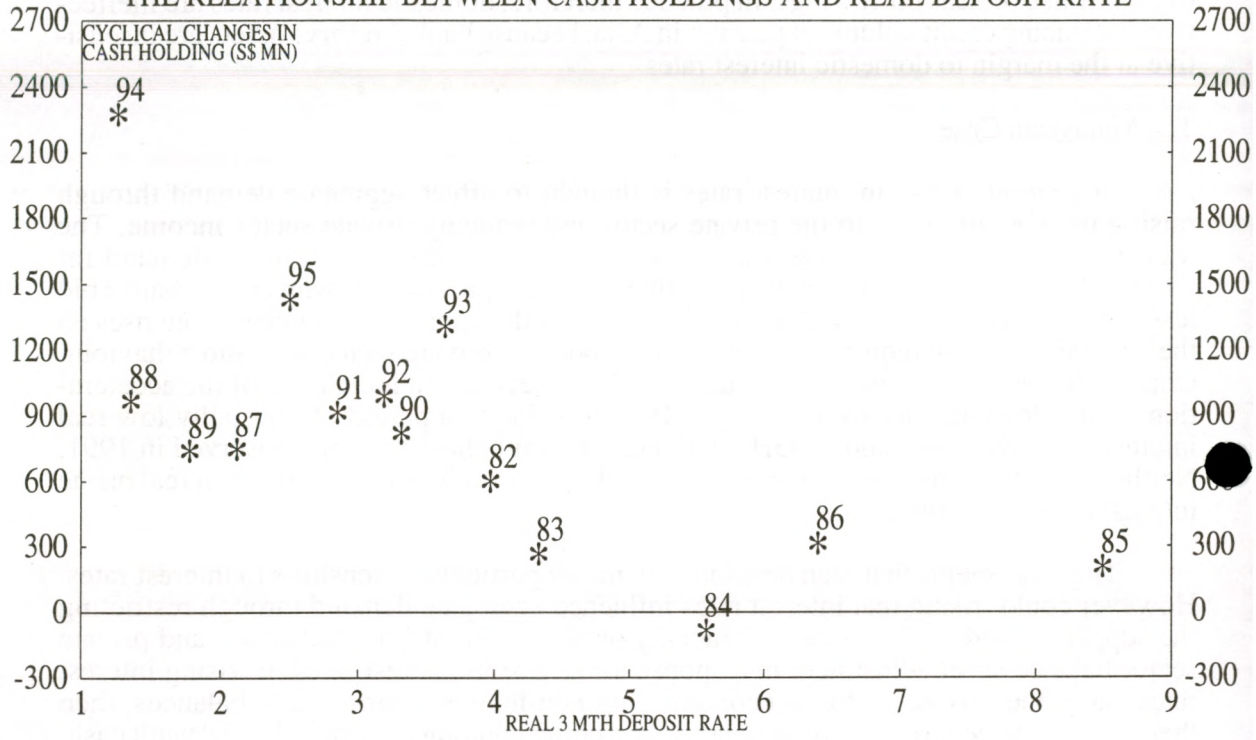
Thus it is seems that loan demand may not be particularly sensitive to interest rates. However could rising real interest rates influence aggregate demand through restricting the supply of credit? This depends crucially on the nature of financial sector and private sector balance sheet adjustment in response to the rise in interest rates. If rising interest rates cause the private sector to economise on non-interest bearing cash balances, then there is likely to be growth in bank deposits and corresponding growth in banks' vault cash. Banks are then able to on-lend vault cash giving a potentially counter-intuitive result, whereby multiple loan expansion is possible during a period of rising interest rates (assuming loan demand unchanged). The following paragraphs examine in more detail the credit and money supply implications of rising real interest rates in Malaysia.

Chart 2 shows the movement in private sector cash holdings relative to deposits in Malaysia. On the face of it, the steady upward drift of this line suggests that, there is no cyclical relationship consistent with a change in cash holdings relative to bank deposits, when interest rates rise. On this basis it may be possible to conclude that real interest rates have no predictable impact on bank liabilities, and therefore the adjustment mechanism is entirely based on a diminution in loan demand. However, it is fair to point out that almost all developing countries display a similar characteristic over time, reflecting growing demand for money during economic growth, and the degree to which financial innovation and technological change improve cash management techniques.

In Chart 3, private sector cash holdings over time are de-trended to account for purely cyclical changes with respect to real interest rates. The chart displays a strong negative correlation, which implies that cash holdings are either being spent or placed on deposit with the banking system as interest rates rise. To the extent that the latter are available for on-lending, both actions give rise to the perverse possibility that aggregate demand could actually rise despite rising real interest rates. Turning to bank assets, do banks economise on non-interest bearing assets, such as vault cash, as real interest rates rise? Chart 4 does not suggest any systematic tendency for Malaysian banks to change loan volumes relative to vault cash when real interest rates change. If loan demand were the binding constraint then the ratio in Chart 4 should be expected to fall as interest rates rise. Alternatively, it is also reasonable to expect that in a competitive environment, banks may try to

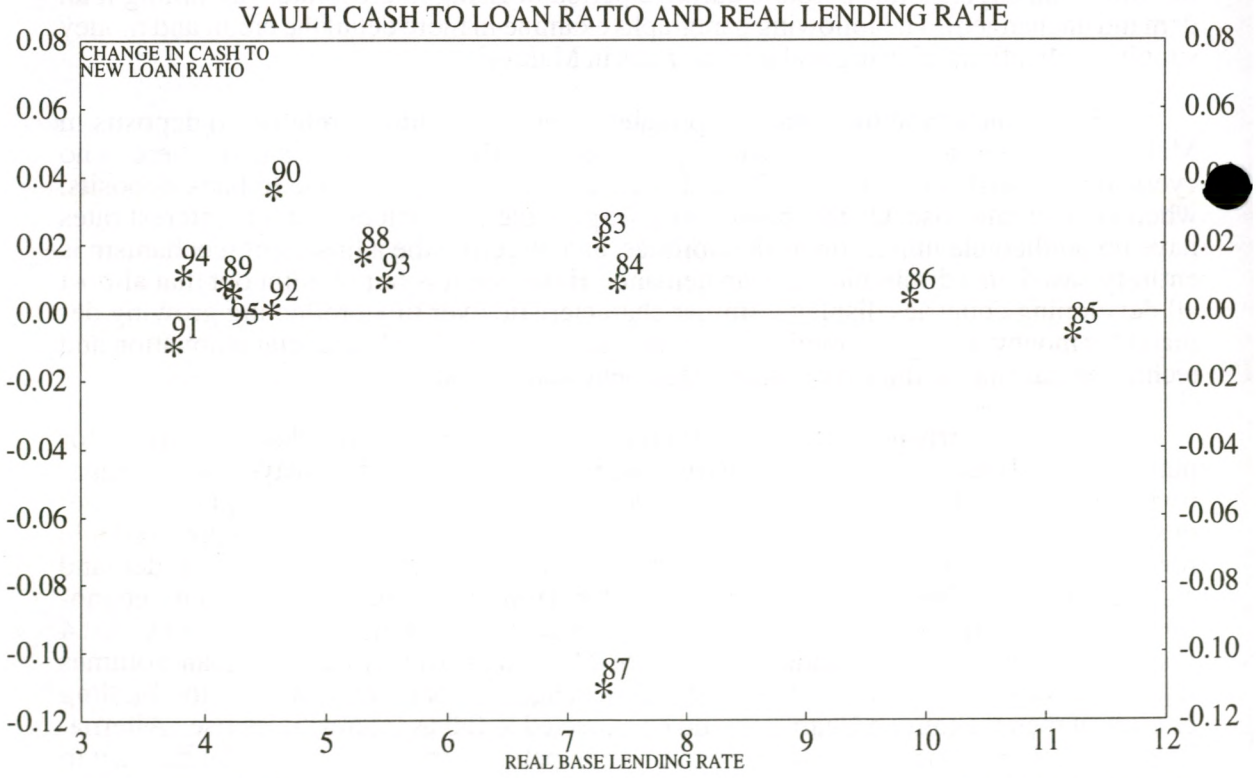
MALAYSIA: CHART 3

THE RELATIONSHIP BETWEEN CASH HOLDINGS AND REAL DEPOSIT RATE



MALAYSIA: CHART 4

VAULT CASH TO LOAN RATIO AND REAL LENDING RATE



maintain volume growth in order to maximise profitability. The conclusion from the results in Chart 4 must be that there exists no clear historical relationship between real interest rates and the supply of credit; at least not clear enough to suggest that real interest rates may be influencing aggregate demand (either way) through this route.

High Interest Rates are Politically Sensitive

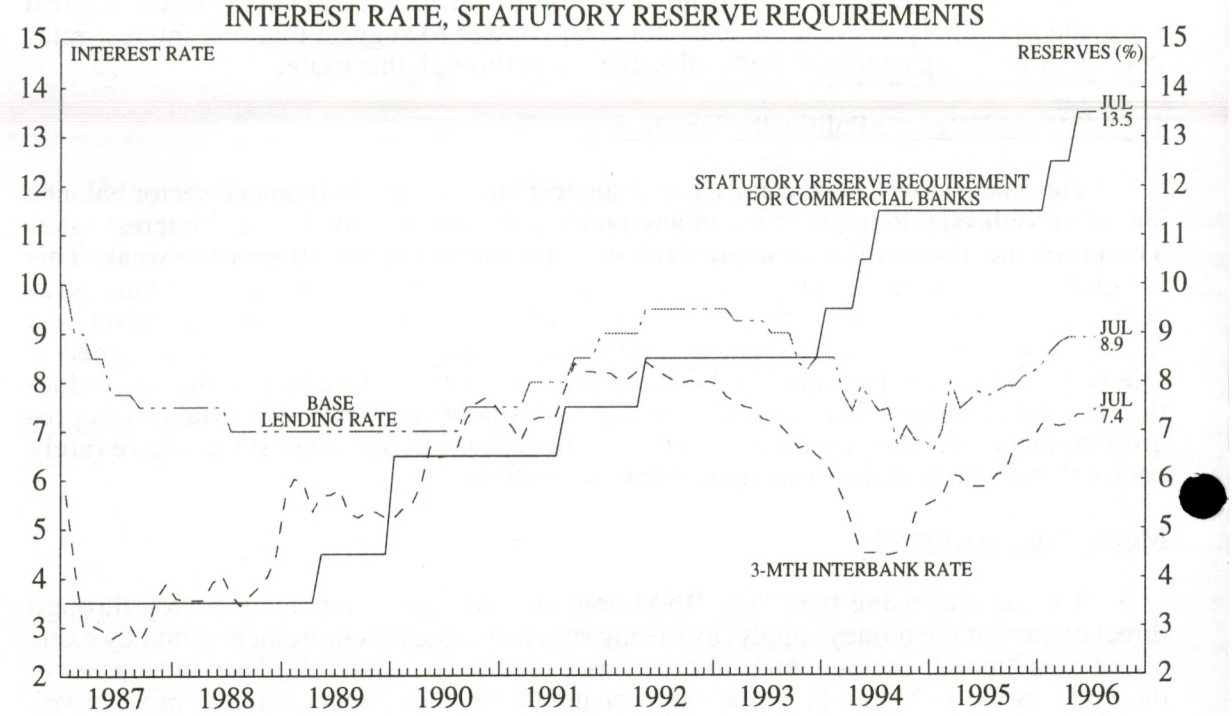
The analyses of Charts 2 and Chart 3 suggest that changes in financial sector balance sheets in Malaysia do not respond in any predictable way to domestic real interest rates. Therefore, the impact of on an interest rise on aggregate demand is likely to be weak. This is especially true if the link between loan demand and real interest rates is also tenuous (as suggested in Chart 1). The weak conclusion from the above must be that while real interest rates may influence domestic demand at the margin, they may need to be maintained at relatively high levels, perhaps for prolonged periods of time, before there is marked reduction in the demand for loans. Such a policy has usually conflicted with Malaysia's pro-growth stance over the past decade, so that cyclical peaks in real interest rates have rarely been sufficient to curb domestic demand by themselves.

Money Supply Control

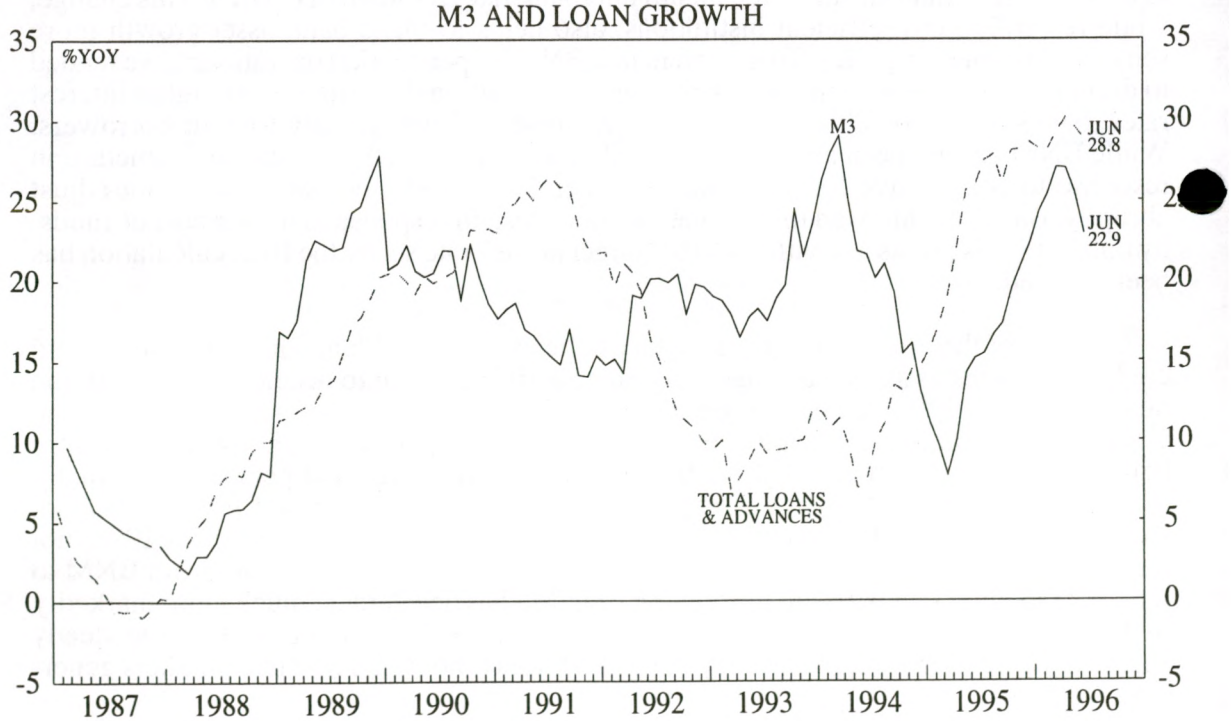
It is not surprising then that BNM continues to tighten monetary policy through direct control of the money supply; by raising statutory reserve requirements, and by exercising tight "moral" pressure on banks to restrict credit expansion (like Thailand, earlier in the cycle, BNM in Malaysia is also emphasising the need to direct credit to "productive" sectors). Reserve requirements on banks have been raised twice this year as shown in Chart 5. In each case banks have responded by raising prime rates. In November 1995, BNM changed the method for calculating the bank lending rate (BLR), linking it directly to banks' cost of funds i.e the three month interbank rate as shown in Chart 5. This change, while rewarding cost efficient institutions, also helps to make bank asset growth more sensitive to monetary policy. To the extent that BNM's open market operations have tended to drain liquidity through the interbank market by inviting deposits at ever higher interest rates, banks automatically pass on the higher cost of funds directly to their borrowers. While BNM has not been averse to a general upward move in the interest rate structure in response to competitive forces, it has also been keen to ensure that rates do not adjust abruptly. Banks are allowed to raise their prime rates, in response to higher cost of funds, by only 20 basis points a month until the "target prime" rate set by the BLR calculation has been reached.

Some of the impact of tight monetary policies is now evident within the money and credit aggregates as shown in Chart 6. Loan growth has begun to decelerate although the numbers in June 1996 may be distorted downwards by the purchase of housing loans by the Cagamas corporation, following a recent bond issue. The purchase of housing loans from banks, while slowing the rate of credit expansion from a statistical perspective actually increases the liquidity of banks asset portfolios, and thus the potential for banks to lend. Nevertheless loan growth should continue to decelerate over the remainder of 1996, not least because loans are coming off a high base in 1995, but also as pressure from BNM to moderate lending intensifies in the coming year. M3 has decelerated much more markedly in 1996 partly because economic activity is moderating, but also because of the steady trickle of short-term foreign currency out of Malaysia (and Asian financial markets generally).

MALAYSIA:CHART 5
INTEREST RATE, STATUTORY RESERVE REQUIREMENTS



MALAYSIA: CHART 6
M3 AND LOAN GROWTH



Further Tightening in Prospect

The recent, albeit slight, moderation in loan growth is encouraging, but inflationary pressure will remain a challenging problem in Malaysia for as long as money supply growth remains well above 20% YoY and the economy is operating at above capacity (assuming potential GDP growth around 7.5%). We have stressed on previous occasions that a significant proportion of the CPI remains under either direct or indirect government control. On other measures, for instance unit manufacturing labour costs shown in Chart 7 inflationary pressure has been strong over 1995 and 1996.

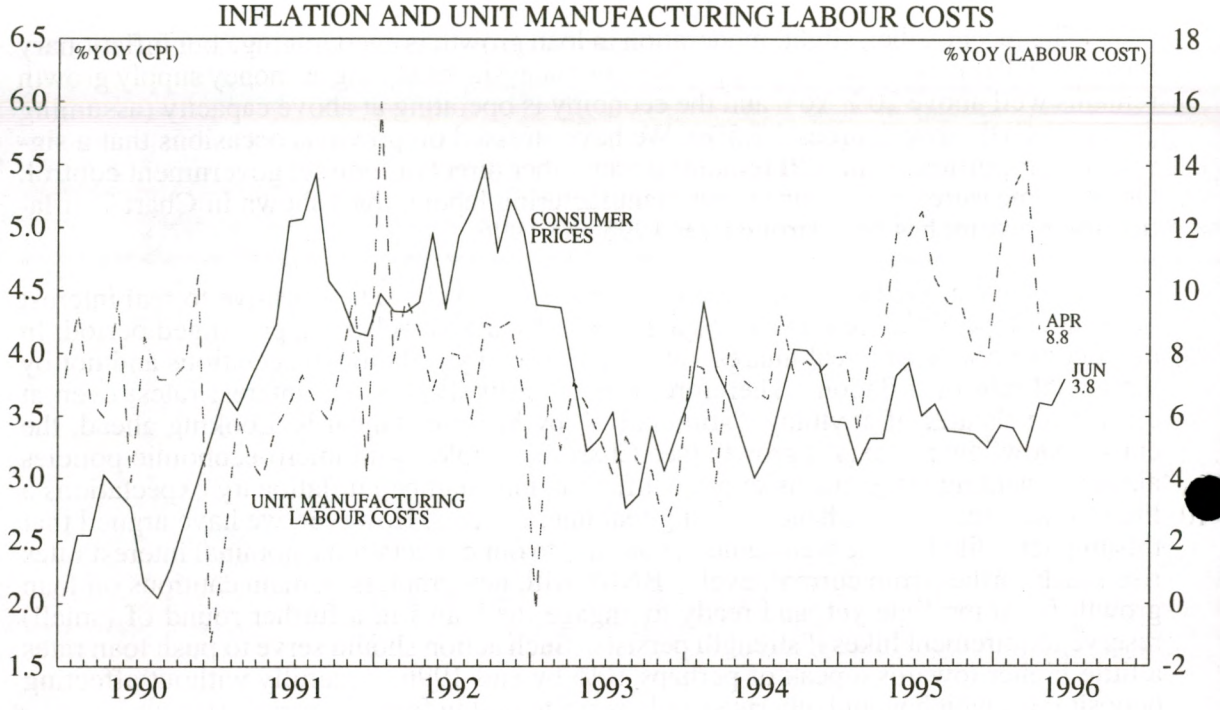
We have argued so far that loan demand is not likely to be sensitive to real interest rates unless the latter are maintained at historically high levels for a prolonged period. In practice the notion of a real interest rate is governed by inflation expectations and not by the actual rate of inflation. Therefore, it is quite likely that real interest rates, even at current levels are, if anything, "stimulative" by historic standards. Looking ahead, the current slowdown in export growth (see Chart 8), coupled with micro-economic policies aimed at tackling wage and asset price inflation, may dampen inflationary expectations a little in the coming year; hence raising real interest rates. However, we have argued that this impact is likely to be weak unless, contrary to our expectations, nominal interest rates rise much further from current levels. BNM will, nevertheless, remain cautious on loan growth for some time yet, and ready to engage the banks in a further round of (small) reserve requirement hikes if strength persists. Such action should serve to push loan rates a little higher towards a peak of perhaps 10% by end-1996 (hopefully without affecting deposit rates which would otherwise only serve to pull in foreign currency).

Balance of Payments and the Currency

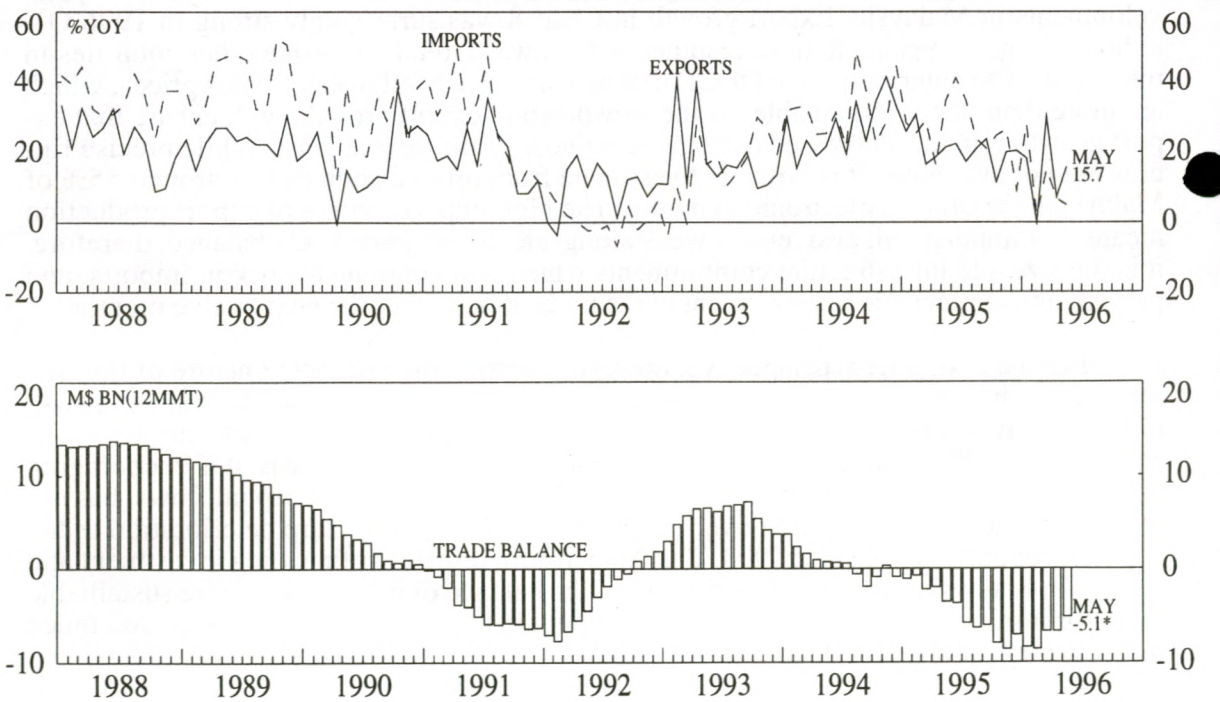
History suggests that balance of payments trends determine long-term monetary developments in Malaysia. Export growth in Chart 8 was surprisingly strong in 1996 Q1, although it now appears to have resumed a downward trend alongside other countries in the region. The deterioration in OECD demand, and sharp fall in electronics prices, which are more than likely responsible for the slowdown in export growth, will ensure that export growth remains depressed over the remainder of the year at least. While precise figures are not available, it is possible to estimate from official sources that around 55% of Malaysian exports are electronic in nature. The high import content of export production means that imports will also remain weak alongside export growth. On balance, therefore, it is the sizeable infrastructure commitments which will continue to suck in imports, and prevent any appreciable improvement in the trade deficit, over the next twelve months.

From a longer term perspective, however, despite the protracted nature of the current cycle, there is reason to be sanguine about the sustainability of Malaysia's growth model. Chart 9 shows the breakdown of Malaysia's balance of payments into it various components. While this breakdown is only available on an annual basis, it is encouraging that the basic balance, the current account deficit plus net long-term capital flows, has not moved substantially into deficit over the past decade, despite a sharp deterioration in the current account balance since 1993. This longer-term profile for financing investment and growth in Malaysia, suggests the structure of the balance of payments is more sustainable than, for instance, in Thailand, where investment led-growth appears to be funded much more through short-term debt.

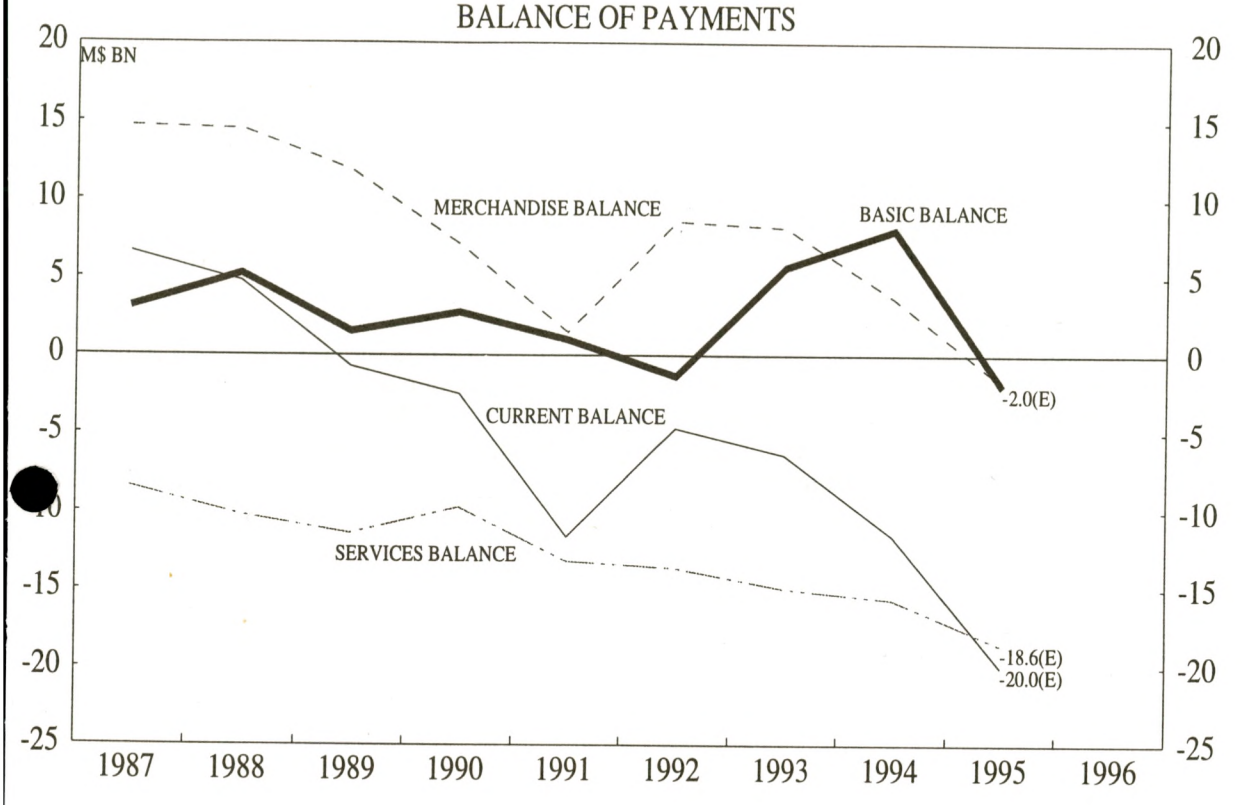
MALAYSIA: CHART 7
INFLATION AND UNIT MANUFACTURING LABOUR COSTS



MALAYSIA: CHART 8
TRADE PERFORMANCE



MALAYSIA: CHART 9
BALANCE OF PAYMENTS



The trade accounts suggest that the ringgit should be weakening although strength so far in 1996 has derived mainly from expectations of rising domestic interest rates. These expectations are not likely to recede for some time, but the prospects for a rise in US interest rates and deteriorating trade accounts will increasingly dominate currency market dynamics. The behaviour of the ringgit over the past year suggests that BNM is allowing the currency to find its own direction. Nevertheless, policy makers are likely to be echoing exporters' concerns if the ringgit appreciates substantially from current levels. While real exchange rate appreciation may be one method currently under consideration for securing productivity shifts in the export sector, there is little indication of any political appetite at present to pursue such a policy over time. Thus the short-term outlook for the ringgit is probably stable-to-gradually-weaker over the next six months, given unclear and conflicting signals from trade and capital accounts. However, the ringgit is likely to receive strong support over 1997 and beyond from the strength of money demand, high real interest rates, and the need to import capital.

SUMMARY AND CONCLUSIONS: As expected, Malaysia is heading for a mild pause in economic activity over the next twelve months, associated with tightening monetary conditions, and an Asia-wide deceleration in export growth. We have shown in this article that aggregate demand is relatively insensitive to real interest rates which, in any event, are relatively low if inflation expectations are taken into account. Thus BNM remains cautious and continues to rein in on money supply and credit growth through restricting the supply of reserve assets to the banking system. The slowdown in export growth marks a turning point for the economy, although more tightening cannot be ruled out if the trade accounts show perhaps only mild improvement and inflationary pressures remain. This will probably take the form of another small rise in reserve requirements over the next six months, which could push loan rates up by another 50 basis points. Capital inflows will continue to support the ringgit at current levels around Ringgit 2.50 to the US dollar, although to a lesser degree over the coming year as trade accounts deteriorate once again. The magnitude of any US interest hikes over the next year will also dampen capital inflows and soften the ringgit. Overall, the slowdown in export growth will assist BNM in successfully achieving a gentle economic slowdown over the coming year, although monetary policy is unlikely to relax significantly over that time frame.

NEW ZEALAND
FIGHTING INFLATION IN AN OPEN ECONOMY

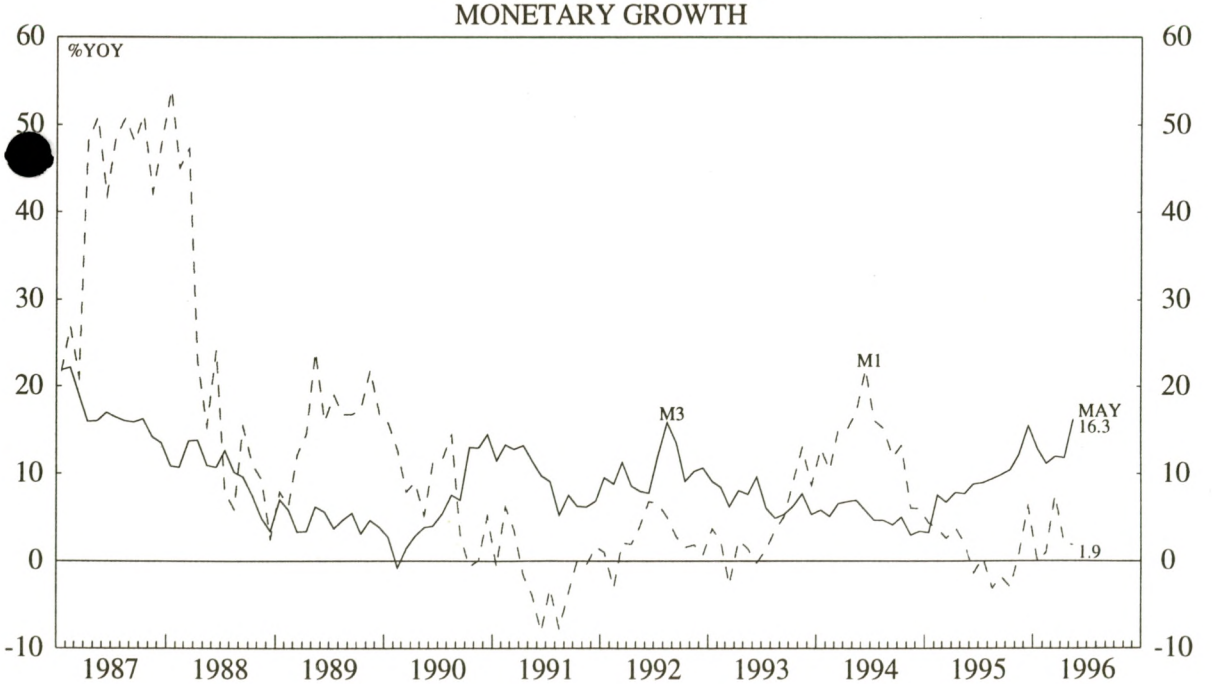
The Reserve Bank of New Zealand (RBNZ) has been waging a long battle against rising inflation since it started tightening Monetary policy in early 1994. Since our last update ("New Zealand: Close to the Peak in Interest Rates" AMM May-June 1996 Vol.20 No.3) the RBNZ has upped the ante with the projections in its latest Monetary Policy Statement that the underlying rate of inflation will continue breaching the target range throughout 1996, and that short-term interest rates will have to stay high (around 10%) for longer. The subsequent June Quarter underlying inflation rate of 0.8% quarter on quarter and 2.3% year on year was marginally higher than even the RBNZ had projected, and would seem to vindicate the decision to keep monetary policy tight for a longer time period.

However, in this article we argue that monetary conditions are tighter than suggested by the monetary aggregates, that this has already exerted a serious negative impact on the real economy, and that the main pocket of inflationary pressure -- the property market -- is now beginning to display significant weakness.

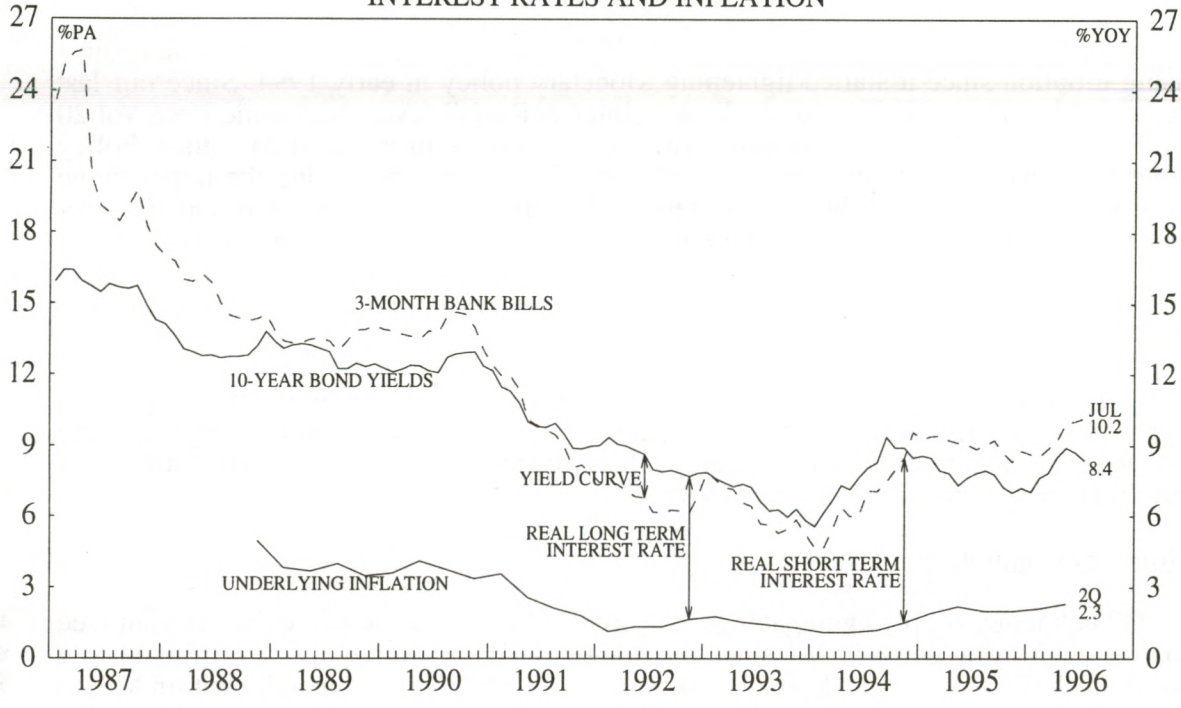
Monetary Conditions

The money supply aggregates in New Zealand appear to be still quite buoyant (see chart 1). The slowdown in M1 since the middle of 1994 can largely be attributed to a portfolio shift from demand deposits into deposits outside M1 (but generally within M3) in response to high and so far rising time deposit interest rates. Indeed, M3 has continued to accelerate in spite of rising interest rates and an avowedly tight stance of monetary policy. What could possibly be the cause for this resilience of broad money supply growth?

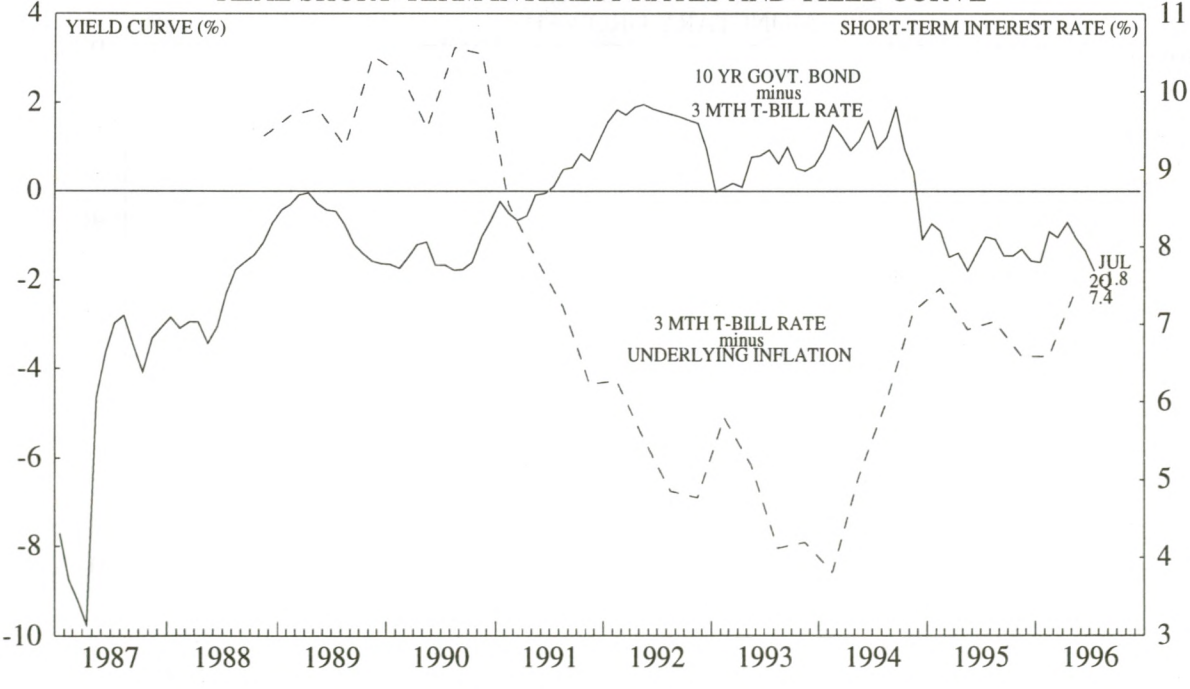
NEW ZEALAND: CHART 1
MONETARY GROWTH



NEW ZEALAND: CHART 2
INTEREST RATES AND INFLATION



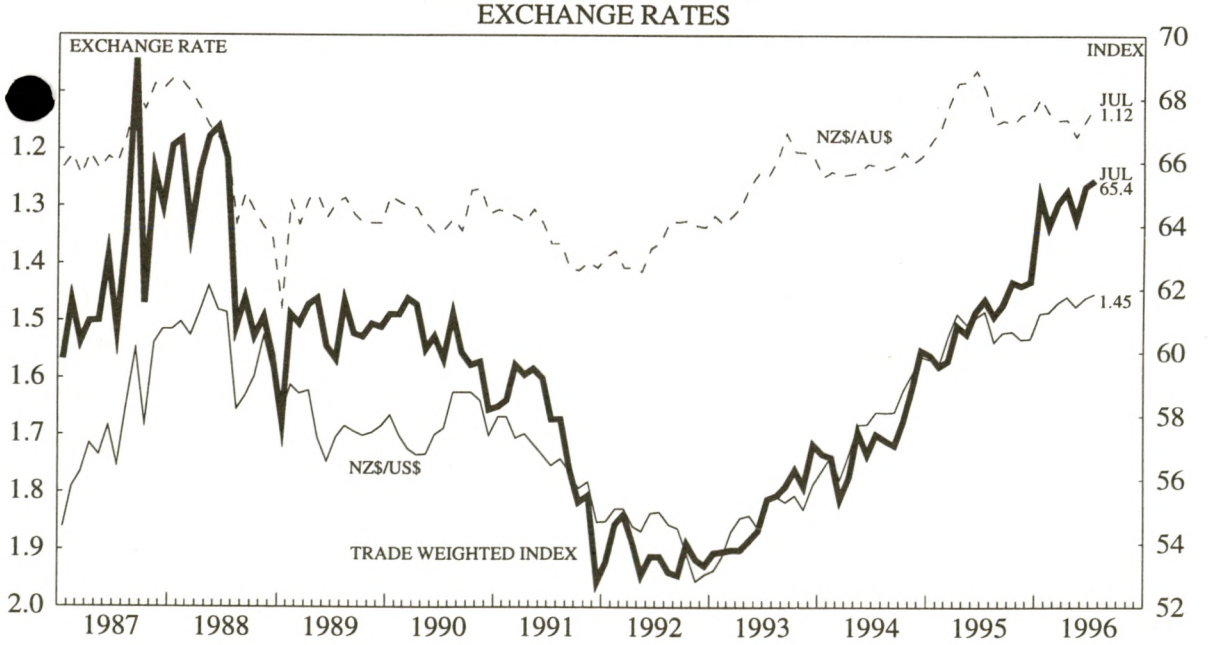
NEW ZEALAND: CHART 3
REAL SHORT-TERM INTEREST RATES AND YIELD CURVE



What New Zealand is experiencing is a variation of the classic Mundell-Fleming dilemma of how to conduct monetary policy in a small open economy. Simply put, the dilemma is that with an open capital account the monetary authorities can control either the quantity of money in circulation (in terms of M1 or M3 or some other aggregate) or the price of money (in terms of the exchange rate or interest rates or some combination thereof). Over the past decade, with the increasing openness of capital accounts, we have seen several countries in the Asia-Pacific Region wrestle with somewhat similar policy dilemmas. Most countries in the region have come to the conclusion that the quantity of money is too difficult to control, and that policy should be focused on facilitating stable exchange rates and appropriate levels of interest rates.

Ultimately the objective of monetary policy should be to control inflation; in the case of New Zealand, the government has charged the RBNZ with the objective of keeping underlying inflation within a 0-2% target range. In terms of intermediate targets, the RBNZ has shied away from monetary aggregate targeting, partly due to the volatility of New Zealand's monetary aggregates and the instability of the relationship between these aggregates and nominal income, and partly due to what they see as the mixed experience of monetary targeting elsewhere in the world. A strong argument in favour of some sort of exchange rate targeting is the high share of trade in national income (70%) and of traded goods in the RBNZ's underlying measure of inflation (58%). However, given the problems of exchange rate targeting (necessity for active foreign exchange intervention, susceptibility to 'speculative attacks', etc.) the RBNZ has chosen to define monetary conditions in terms of a combination of the Trade Weighted Index (TWI) of the exchange rate and 90 day bank bill rates. While both these rates are market determined, the RBNZ uses its regular Monetary Policy Statements and other opportunities to indicate to the market whether monetary conditions are appropriate. Ultimately, the RBNZ can directly affect monetary conditions by altering the cash balances of the banking system, although this is a rarely used weapon which is merely kept in reserve as an implicit 'credible threat' behind the RBNZ's usual 'open mouth' operations.

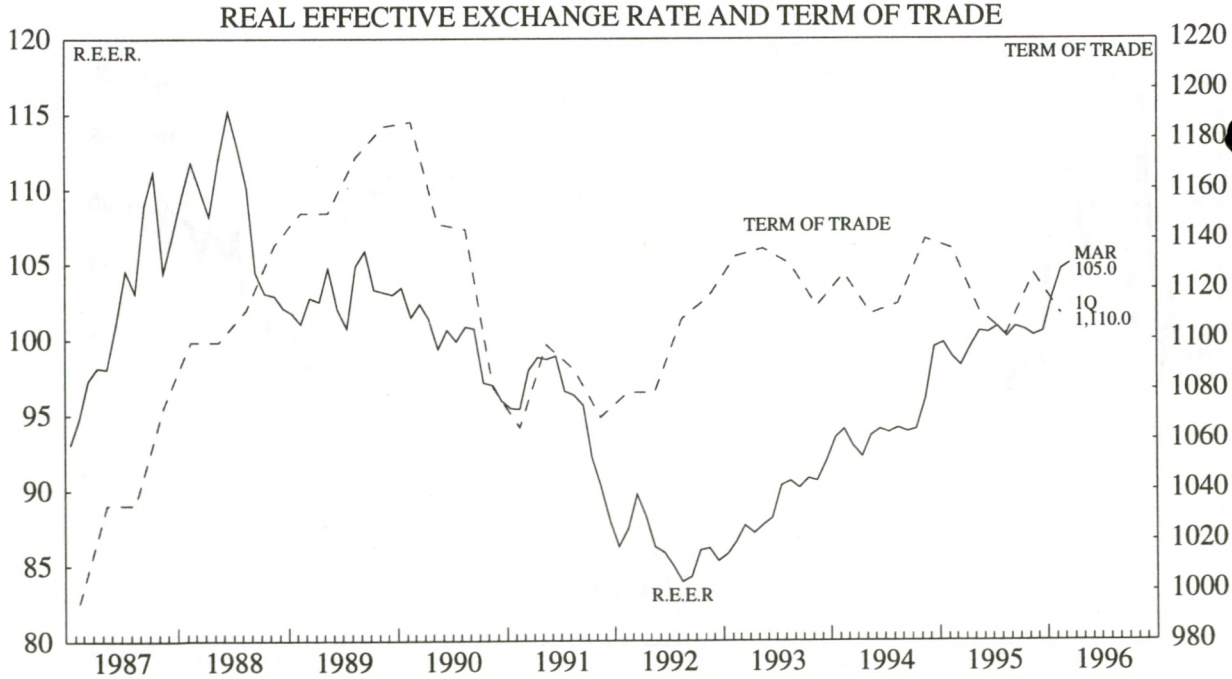
NEW ZEALAND: CHART 4
EXCHANGE RATES



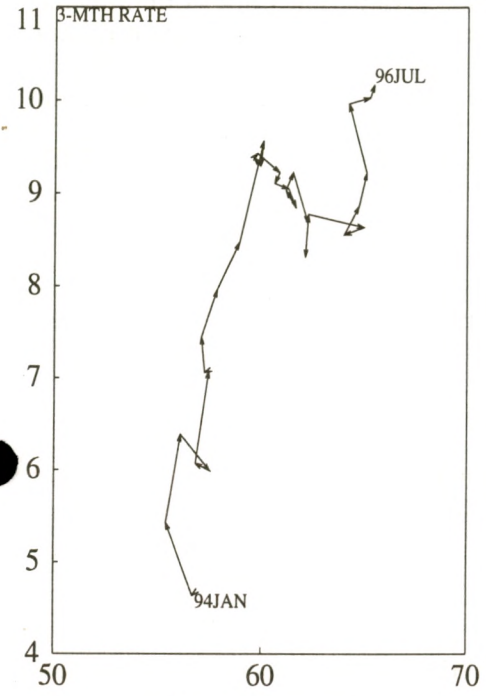
In this cycle the RBNZ has been particularly proactive in tightening monetary policy at the first sign of incipient inflationary pressures in early 1994. The tightening involved pushing up 3 month bank bill rates from around 4.6% at the beginning of 1994 to 10% recently (see chart 2). This gave New Zealand exceptionally high short-term real interest rates and made it the first OECD country with an inverted yield curve in the current cycle (see chart 3). In order to reduce imported inflation, the tightening of monetary policy also involved aggressive appreciation of the currency against both the US$ and on a Trade Weighted (TWI) basis (see chart 4). Given the low rate of inflation in New Zealand, such nominal exchange rate appreciation resulted in a strengthening of the country's terms of trade and an appreciation of its real effective exchange rate (see chart 5). Looking at the path over the past three years of interest rates and the exchange rate in both nominal and real terms, it is clear that monetary conditions have tightened continually, although the brunt of the tightening has been felt initially on the exchange and only more recently on interest rates (see chart 6).

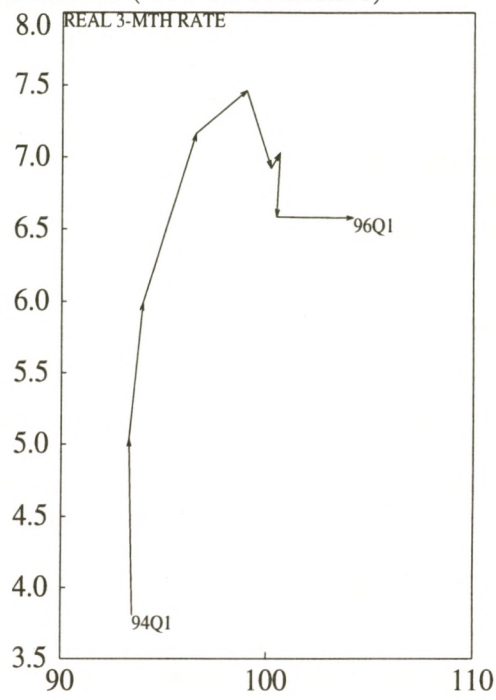
As mentioned earlier, the high real deposit rates attracted funds from other assets into interest bearing deposits within M3. In a closed economy such portfolio-shifts would be limited by the amount of funds held in other assets and by the ability and willingness of the domestic banking system to expand their balance sheets in the face of the low spreads implied by an inverted yield curve. In a small economy with an open capital account, however, the external sector can provide an almost infinite supply of funds to the system. The limiting factors to such inflows are the propensity for foreigners to invest and the availability of domestic assets for foreigners to purchase. An extra attraction for New Zealand dollar assets was the policy of continuous currency appreciation to avoid imported inflation, and the credibility that the policy framework has earned since its establishment. In summary, an externally credible monetary policy framework of high interest rates and continual currency appreciation will almost certainly attract foreign capital inflows which boost the money supply.

NEW ZEALAND: CHART 5
REAL EFFECTIVE EXCHANGE RATE AND TERM OF TRADE

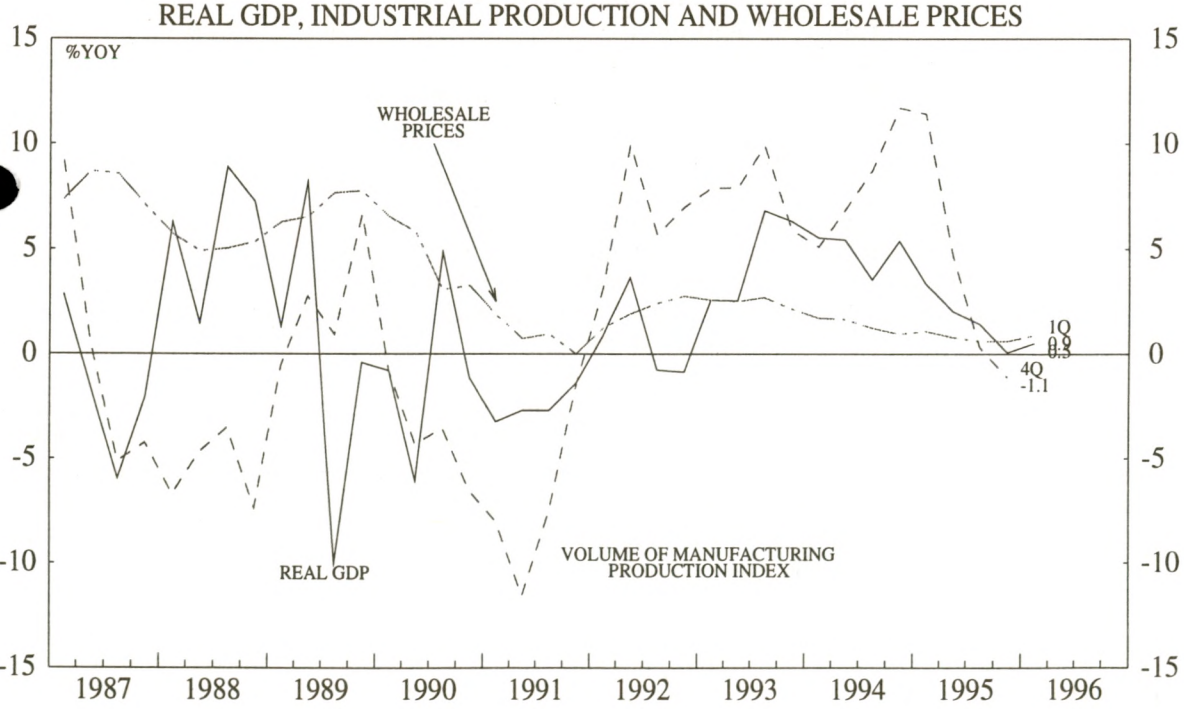


NEW ZEALAND: CHART 6
RECENT CHANGES IN MONETARY CONDITIONS (1994 TO PRESENT)





NEW ZEALAND: CHART 7
REAL GDP, INDUSTRIAL PRODUCTION AND WHOLESALE PRICES



As mentioned earlier, some Asian countries have faced similar but slightly different policy dilemmas. Typically they have tried to control domestic demand with high interest rates, while attempting to maintain stability of the exchange rate. The policy dilemma has arisen when resulting capital inflows have become strong enough to boost local money supply growth, put downward pressure on domestic interest rates, and/or put upward pressure on the exchange rate. One response to this policy dilemma chosen by some Asian countries has been to throw 'grit in the wheels' of capital inflows, through reserve requirements or less attractive interest rates on non-resident deposits, moral suasion on domestic banks not to accept deposits of 'speculative capital', or similar measures. However, besides the intended short run effect of reducing capital inflows and a higher level interest rates in line with official monetary policy, such market unfriendly policy measures risk reducing the long run credibility of any given monetary policy framework and burdening the country with a risk premium on interest rates for a longer period of time than the authorities intend. The RBNZ is very well aware of New Zealand's long term economic reliance on foreign trade and capital flows, and on the importance of policy credibility in combating inflation. The RBNZ has therefore chosen not to try to obstruct the market forces of international capital flows, while hoping that domestic bank's balance-sheet expansion will be curtailed by the inverted yield curve, and that non-resident deposits will not lead to additional inflationary spending-claims on available real resources in the economy.

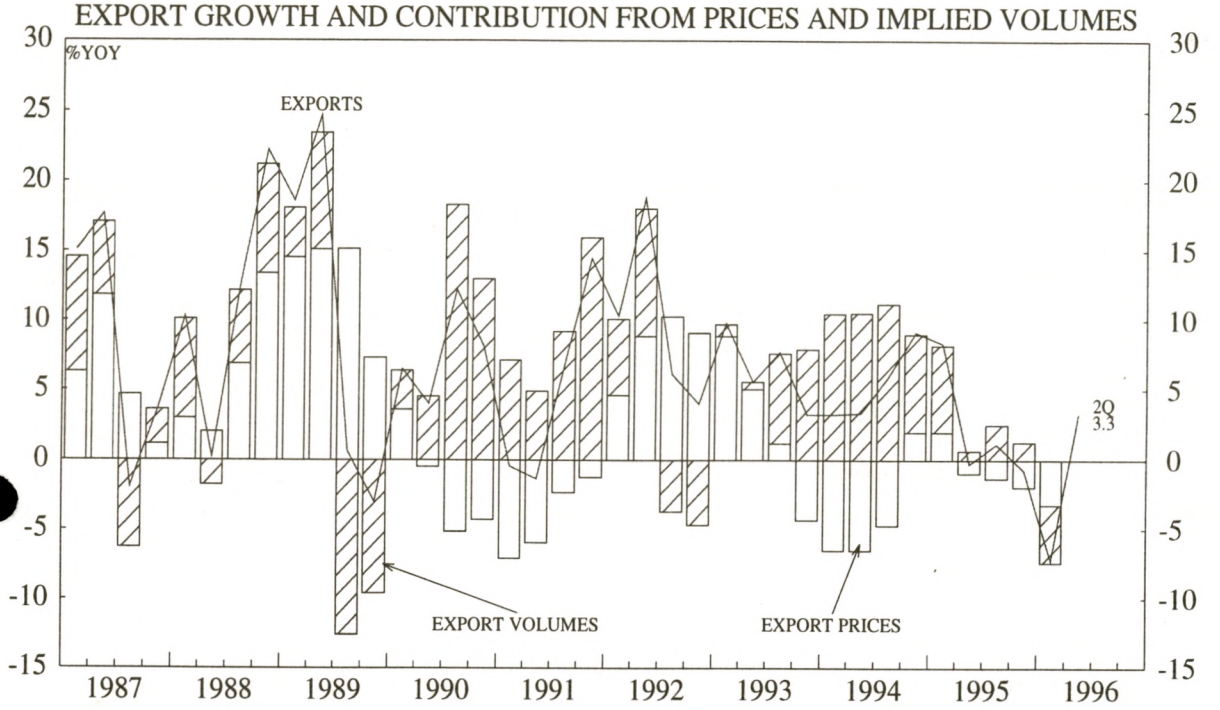
Effect on Real Economy and Inflation

In response to the aggressive tightening of monetary conditions, economic activity has already slowed down significantly, both in terms of GDP, manufacturing and wholesale trade (see chart 7). Given that the brunt of the tightening has been felt on the exchange rate, the only surprising aspect of the resulting downturn in exports (see chart 8) is that it hasn't been more severe -- a tribute to the success of New Zealand's extensive economic reform in creating a more dynamic and competitive economy. Import growth appears to have been boosted during 1994 and the first half of 1995, arguably buoyed up by New Zealand's stronger terms of trade (see chart 9). However, in the past 12 months import growth has clearly slowed, suggesting that the price attractiveness of imports is now outweighed by weaker demand in New Zealand's economy. Overall, the stronger New Zealand dollar appears to have fuelled a deterioration in the trade and current accounts, although probably to a lesser extent than many commentators had feared, thanks to the resilience of the export sector and the eventual slowdown of demand in New Zealand (see chart 10 -- the large gap between the trade and current account balances comprises mainly interest, profit and dividend payments to non-resident holders of New Zealand dollar investments). Two indicators which suggest that the slowdown in demand will continue are the indicators of business and consumer sentiment.

Although the monetary tightening in New Zealand appears tight by almost any standard (other than broad money growth rates), the resilience of the economy has nonetheless pushed the underlying rate of inflation above the 0-2% target range. Given the near-absence of inflation in traded goods due to the aggressive exchange rate appreciation, this meant that a rate of inflation in non-traded goods of closer to 4%. The major area RBNZ inflation concern has been the property market, which for a long time continued to soar in spite of high real interest rates and a general economic slowdown. In New Zealand house prices have a direct impact on the various indicators of inflation, besides any indirect cost push impact on retail prices (through higher shop rents) or demand pull impact on wages in property related industries like construction. The latest data on the property market does

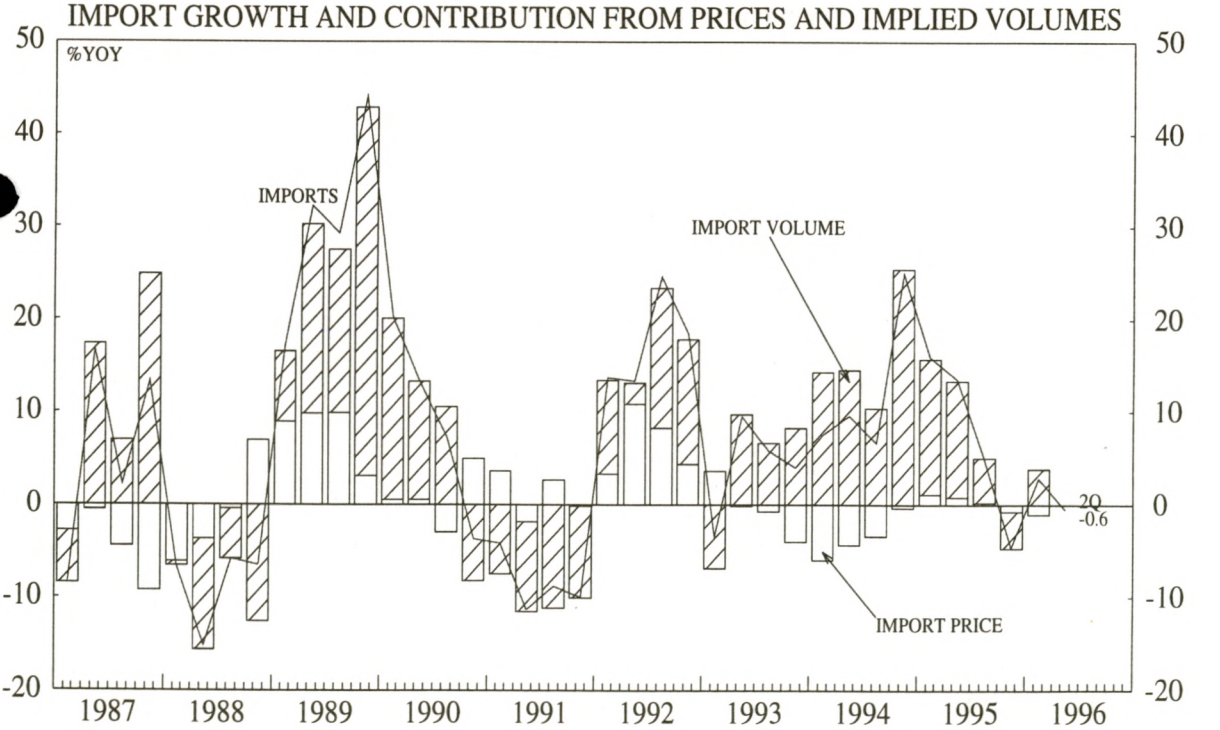
NEW ZEALAND: CHART 8

EXPORT GROWTH AND CONTRIBUTION FROM PRICES AND IMPLIED VOLUMES

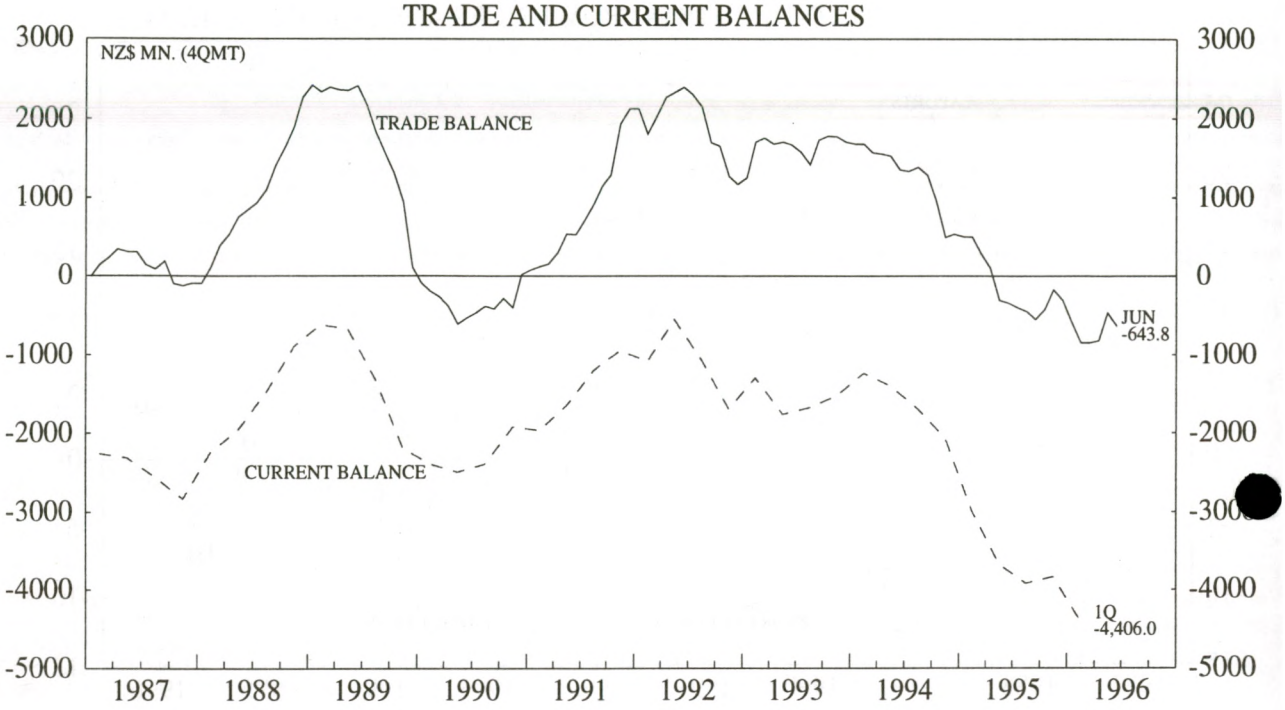


NEW ZEALAND: CHART 9

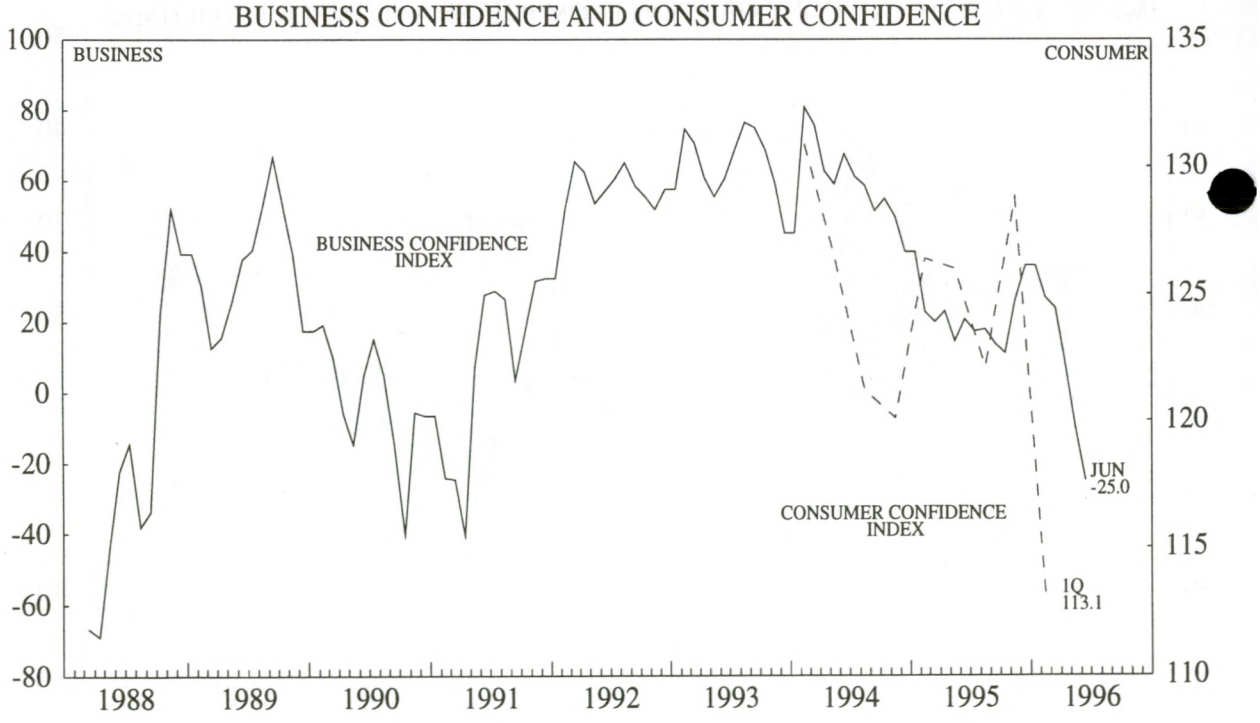
IMPORT GROWTH AND CONTRIBUTION FROM PRICES AND IMPLIED VOLUMES



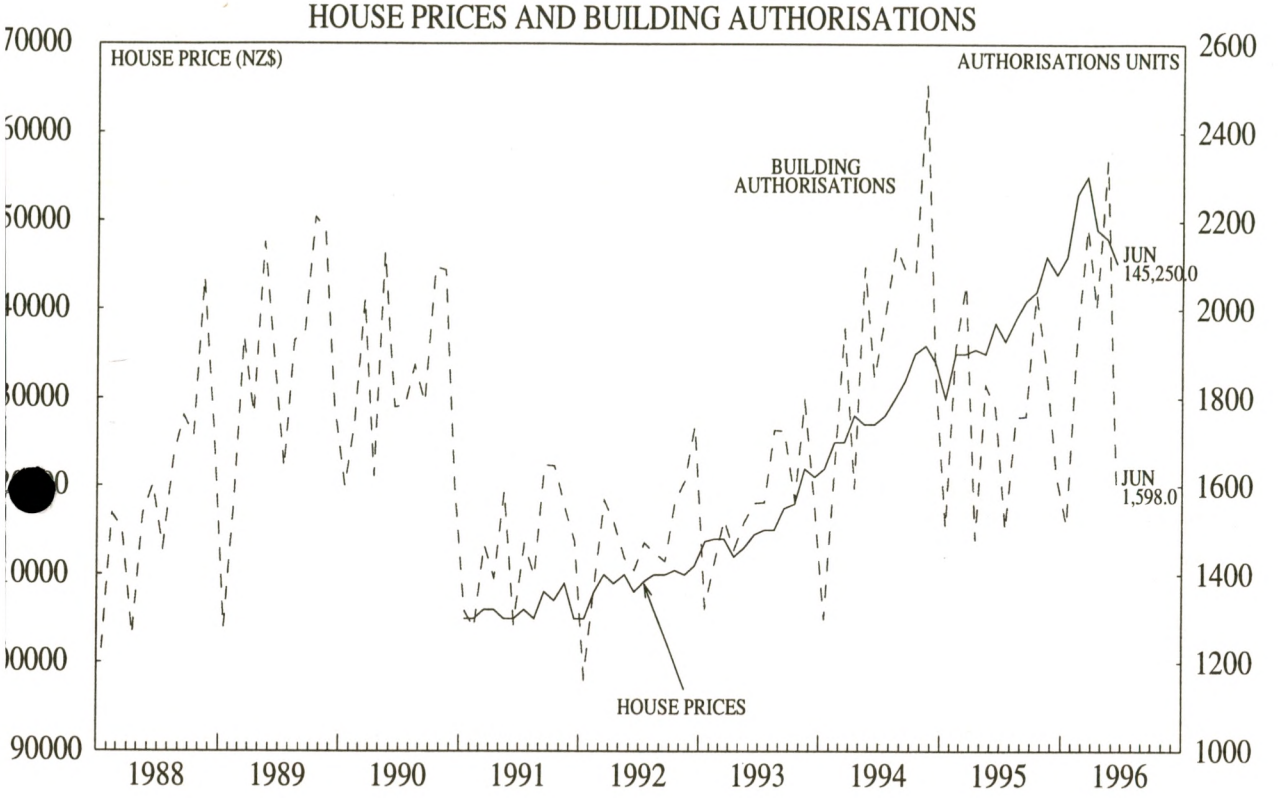
NEW ZEALAND: CHART 10
TRADE AND CURRENT BALANCES



NEW ZEALAND: CHART 11
BUSINESS CONFIDENCE AND CONSUMER CONFIDENCE



NEW ZEALAND: CHART 12
HOUSE PRICES AND BUILDING AUTHORISATIONS



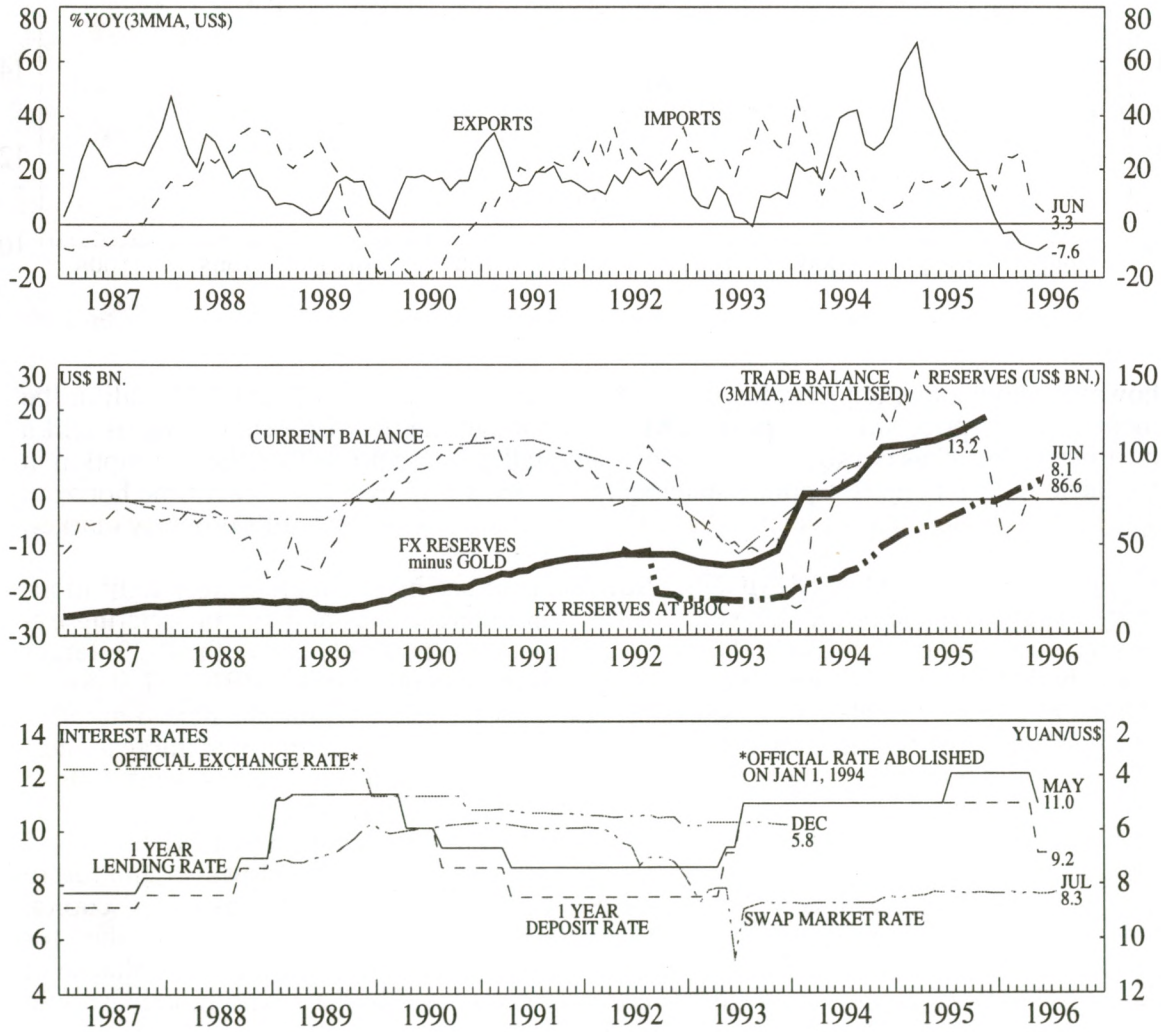
however show a marked slowdown in building permits and a significant 6.3% fall in the median house-price since the peak in March (although the year-on-year change is still a positive 4.9%). This is a significantly more rapid fall in house prices than the assumption in the latest RBNZ monetary policy statement of 'at least 5%' over a 1-2 year time horizon. The high real interest rates seem to have finally impacted New Zealand's property market.

SUMMARY AND CONCLUSIONS: New Zealand has had an increasingly tight monetary policy over the past 2 1/2 years, with rising interest rates and an appreciating exchange rate. Although the underlying rate of inflation is currently above the 0-2% target range, both domestic and international economic developments since the RBNZ's last policy statement could facilitate a modest easing of monetary policy within the next 6 months. The market is now beginning to anticipate lower inflation and lower nominal interest rates. The money market has started to test the RBNZ's resolve to keep 3-month bank bills at 10%, while medium-dated New Zealand government bonds have rallied by over 90 basis points since yields peaked in mid June (helped in large part by falling US bond yields). Real yields in New Zealand are still attractive by international standards. However, the future path of the exchange rate is unlikely to contribute as much to foreign investors' capital gains as it has over the past 2 1/2 years. New Zealand's equity market has languished for the past 2 1/2 years, and is still more than 40% below its 1987 peak. Barring a collapse of New Zealand's economy, an easing of monetary policy within the next 6 months should have a beneficial effect on the equity market.

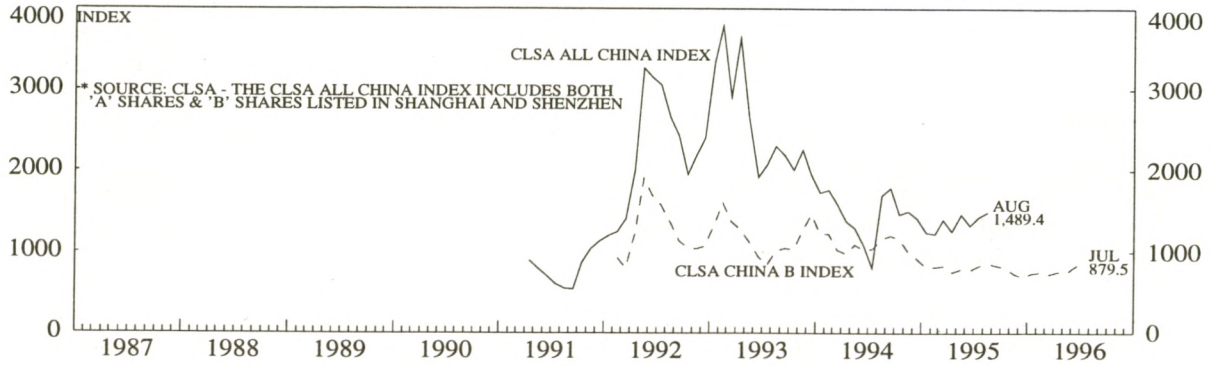
CHINA: ECONOMY TO REBOUND

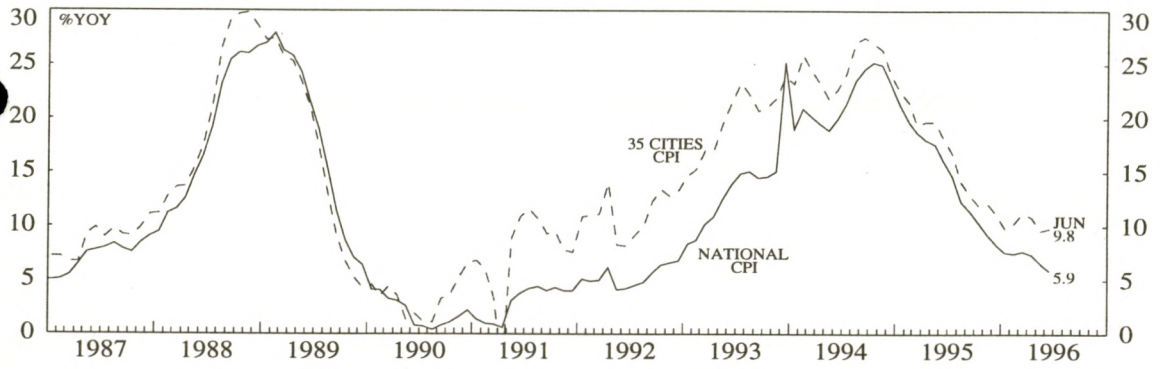
The authorities had imposed relatively tight monetary policy over 1995 and this has slowed down economic activity to the present day. This together with various other restrictions on activity and prices have brought down the rate of growth of the CPI indices to single digits. The authorities were able to stabilise shifts in savings out of the banking system by introducing a subsidy which augments the interest earned on bank deposits and on bonds. The subsidy rose from negligible levels in 1994 to a maximum of 13-14% during 1995 before declining to around 7%. Given the downtrend in inflation and industrial output, the authorities have eased domestic monetary policy. In addition, in April they eliminated subsidies on new deposits and in May, reduced deposit rates. The ongoing rise in the level of foreign exchange reserves, fed by strong capital inflows, has also contributed to an easing in monetary conditions in 1996. Export growth will likely bounce up in the months ahead as the base effects from the reduction in tax rebates to exporters drop out. Imports are also likely to strengthen over 1996-97 as they respond to stronger economic activity and to the staggered withdrawal of tariff concessions on capital goods imports.

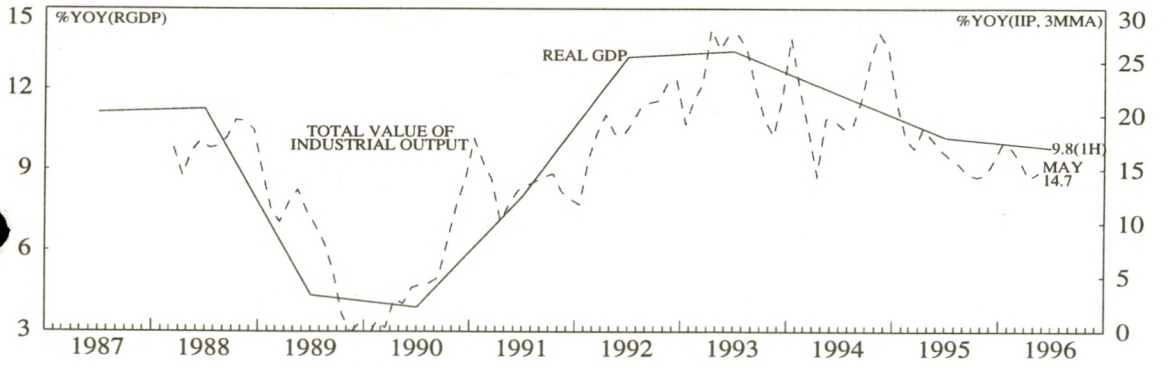
CHINA: MONEY MARKET AND BALANCE OF PAYMENTS

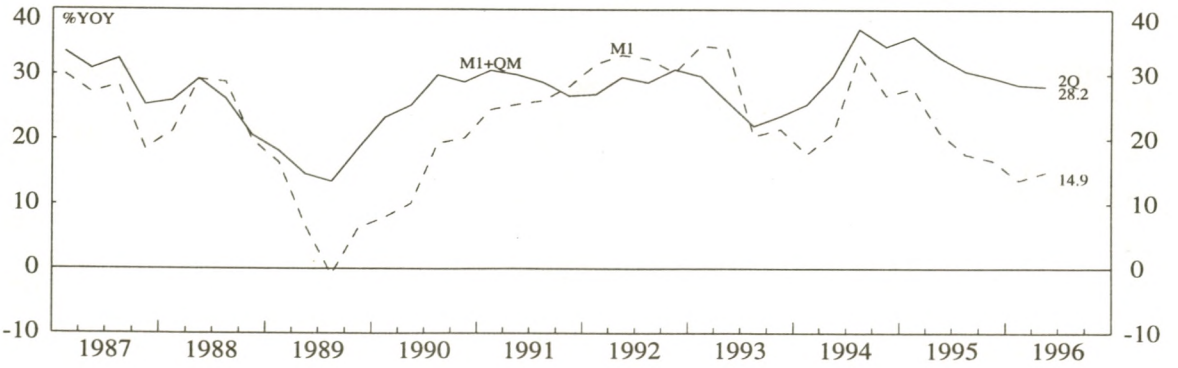


CHINA: MONEY, OUTPUT, GOODS AND ASSET PRICES





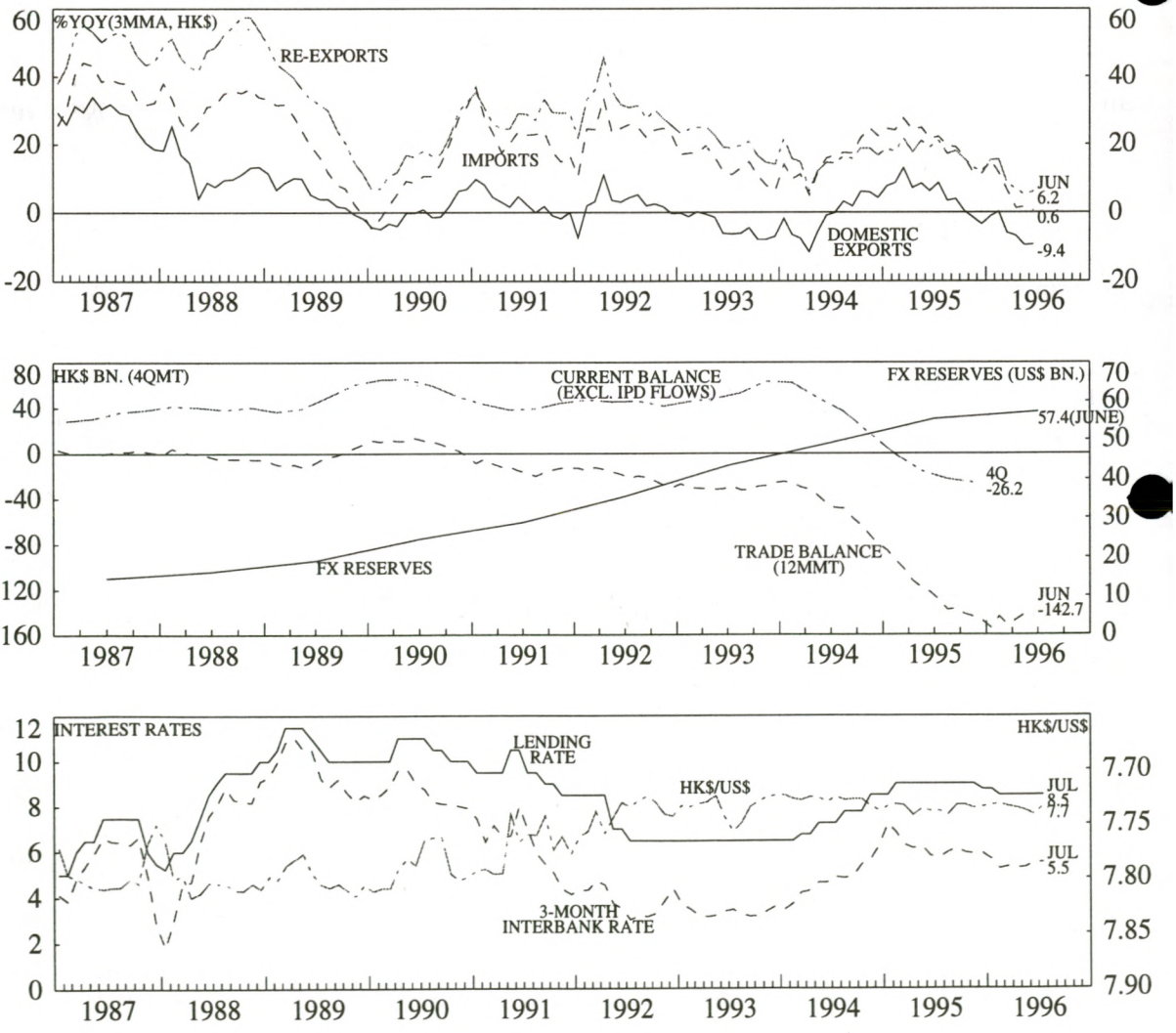




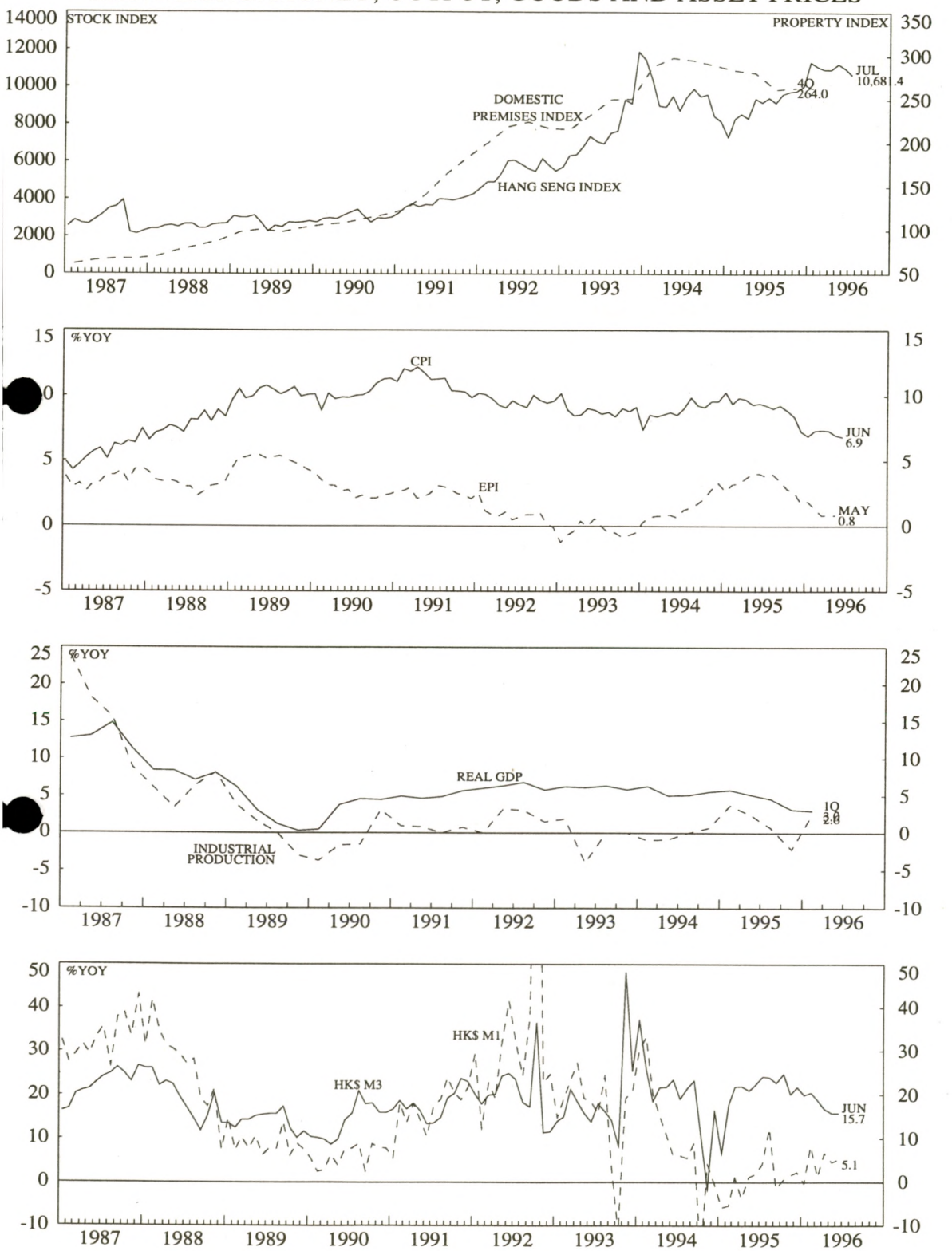
HONG KONG: ANOTHER SLUGGISH YEAR IN PROSPECT

Further deterioration in the trade balance will act to partly offset the tentative recovery in consumption, so that the economy is headed for another year of sluggish growth in 1996. This should ensure that inflation remains subdued for the remainder of 1996 at least. The competition for mortgage finance has kept HK$ denominated lending buoyant although the collapse in foreign currency loans has substantially weakened overall loan growth. Without much impetus, therefore, from either trade accounts or lending, HK$ M3 has decelerated steadily, coming of a relatively high base in 1995. On account of the intense competition to provide mortgage loans, any rise in US interest rates will probably dent, but not stall, nascent recovery of the property sector. The direction of US monetary policy, however, has already dampened upward momentum of Hong Kong's equity market. A slow economy in China this year so far is another factor depressing earnings in Hong Kong generally. Looking ahead, recovery of the Chinese economy later in 1996 and over 1997, will be one of the key factors underpinning a more positive tone for the economy and the stock-market.

HONG KONG: MONEY MARKET AND BALANCE OF PAYMENTS



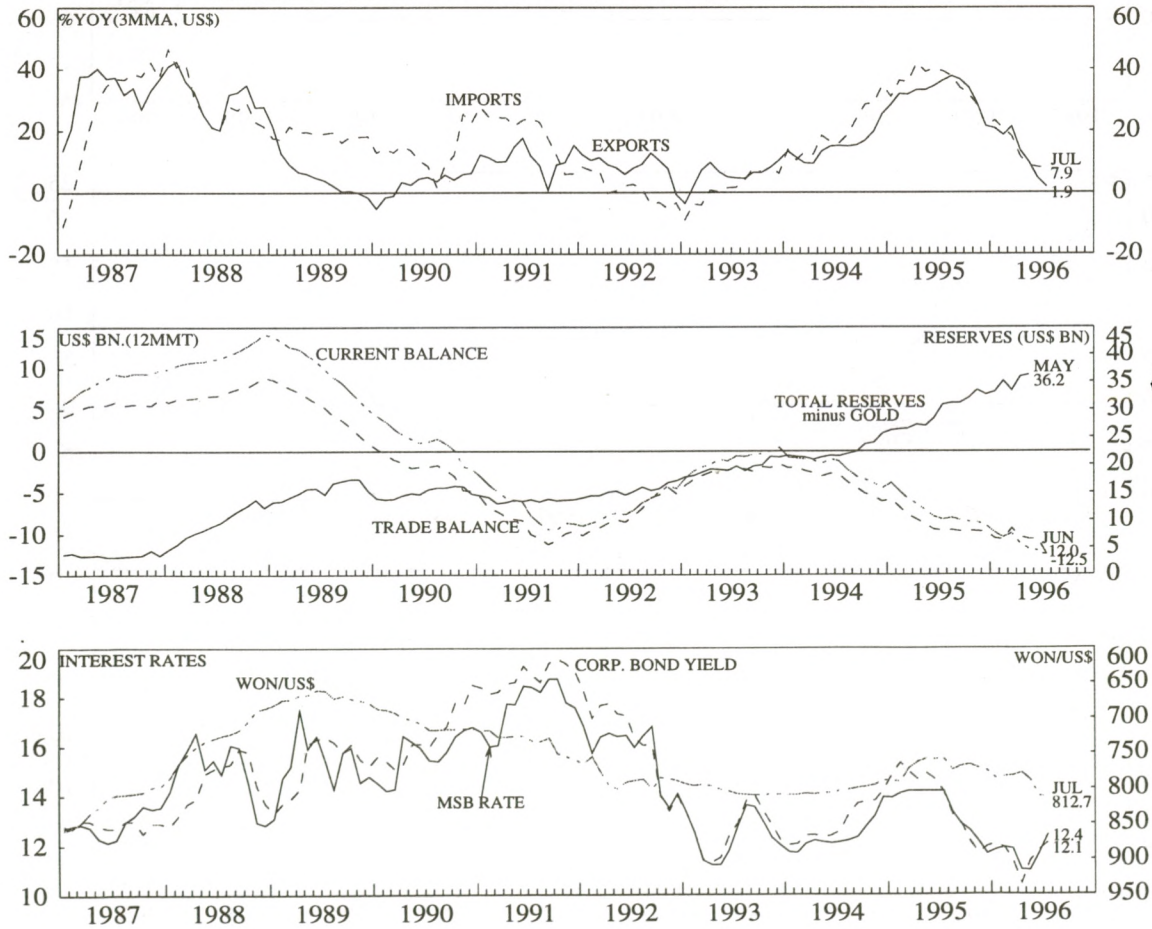
HONG KONG: MONEY, OUTPUT, GOODS AND ASSET PRICES



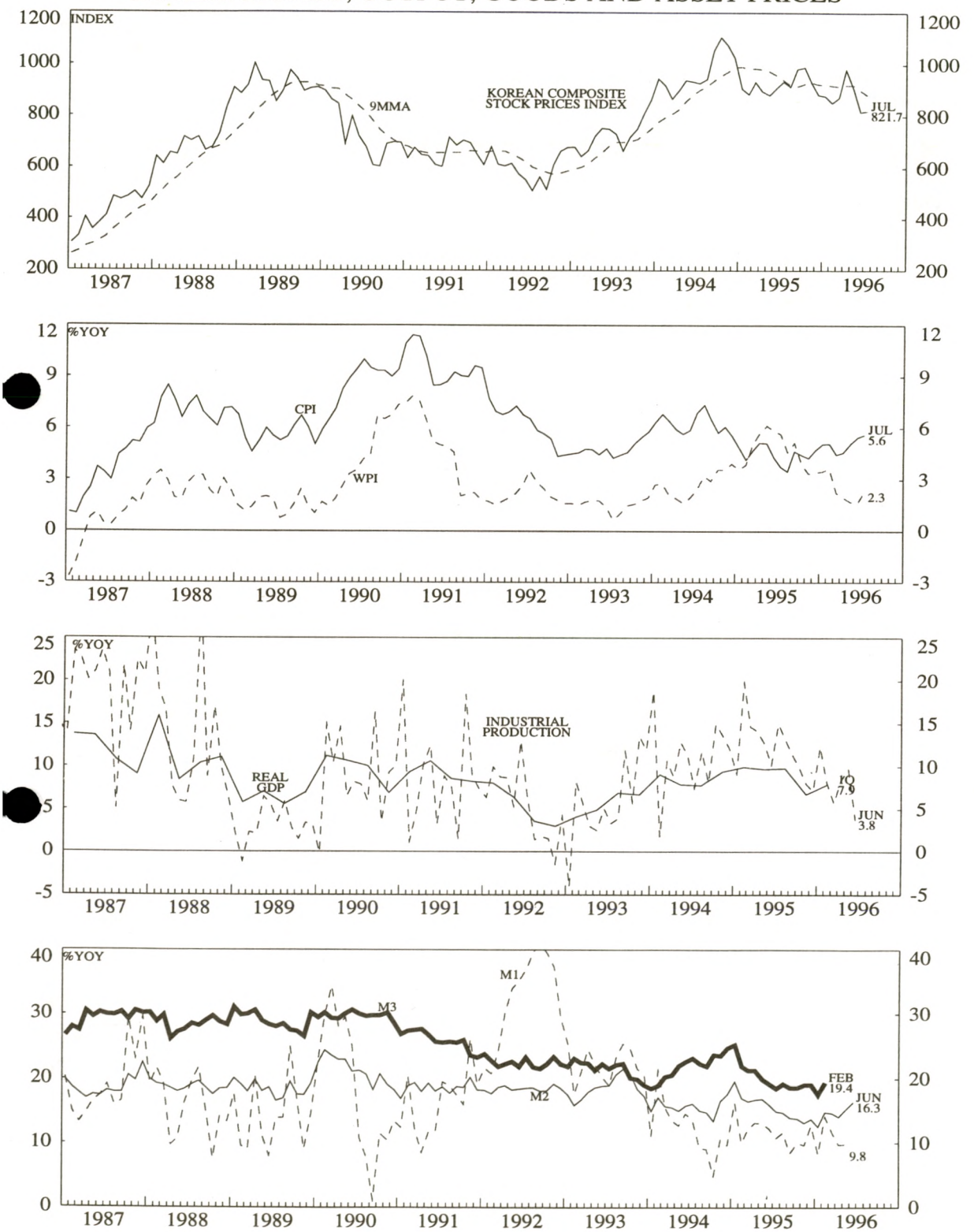
KOREA: SOFT LANDING IN JEOPARDY

Recent trade data paint a bleak picture for the Korean economy in 1996. The collapse in export growth, to 1.9% YoY in July, continues to reflect mainly sluggish OECD demand and a collapse in prices of some key exports such as computer-chips. Import growth outstripped export growth by a wide margin in July, resulting in a cumulative deficit for seven months in 1996 of around US$10 bn -- greater than government expectations for the year as a whole. Besides trade, another factor likely to depress industrial production over the next six months is the disappointing build up in inventories; reminiscent of the build-up which preceded the collapse of economic activity in 1992. Against the backdrop of a potentially weak economy this year, the Bank of Korea's (BoK) monetary policy has been difficult to interpret. Climbing interest rates on Monetary Stabilisation Bonds -- the BoK's main sterilisation instrument -- suggest that the BoK is running a restrictive monetary policy. Perhaps there is concern at ongoing capital inflows, acceleration in M2 growth (beyond the 11.5-15.5% target range), and the attendant risk to inflation. While CPI inflation, as a lagging indicator, has been accelerating through 1996, pipeline inflation on the WPI remains subdued. On the other hand, the Won has been allowed to slip against the US dollar, indicating a looser monetary stance. We continue to expect that monetary and fiscal conditions will be allowed to ease for the remainder of 1996. These conditions should be supportive of a recovery in the beleaguered stock-market.

KOREA: MONEY MARKET AND BALANCE OF PAYMENTS



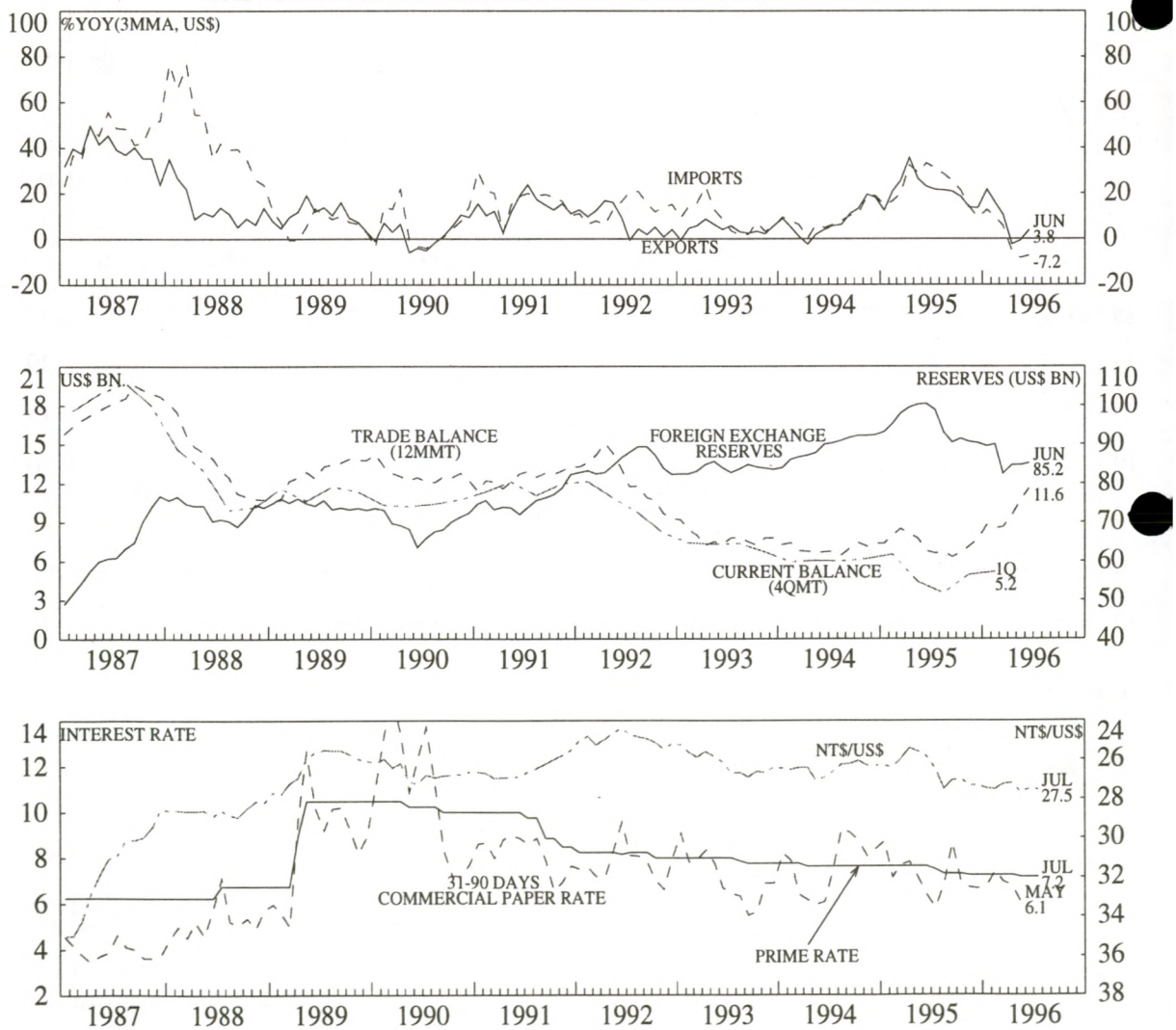
KOREA: MONEY, OUTPUT, GOODS AND ASSET PRICES



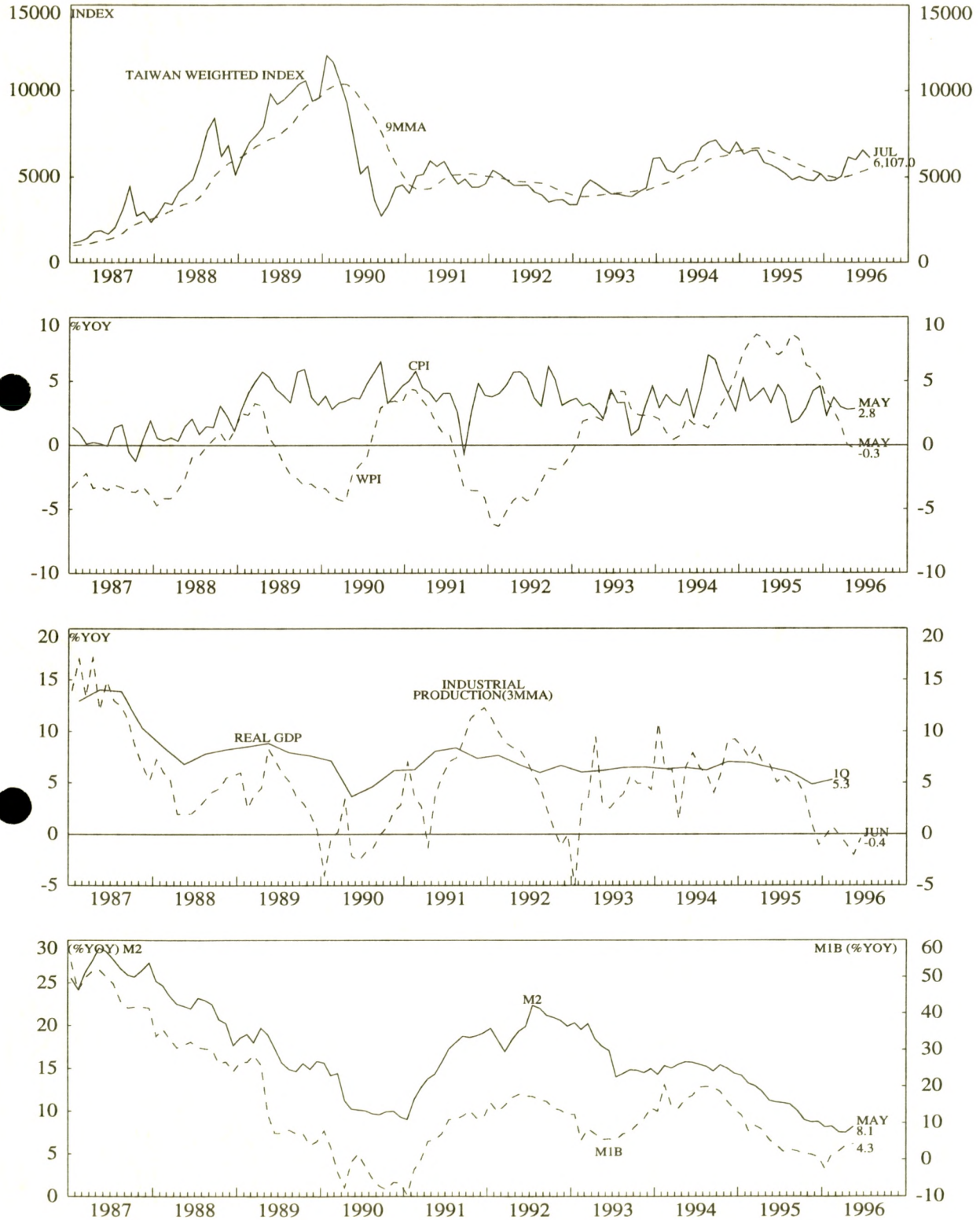
TAIWAN: WEAK EXPORTS HOLD BACK ECONOMY

Over the last 6-9 months Taiwan has been adjusting to two major economic shocks. The first is the politically induced outflow of short-term capital. This lasted from the end of 1995 through the first half of 1996. The effect of this capital outflow has been to cause the central bank to support temporarily the exchange rate at 27.5NT$/US$ and let interest rates rise. This has squeezed liquidity conditions and caused the authorities to lower their M2 growth 'target ranges.' Now that the elections have passed and political tensions are calmer confidence has returned and the central bank is adopting a more stimulative monetary stance. However, the economy will remain more subdued as a result of the monetary slowdown. The second shock that has hit Taiwan is the downturn in the electronics market, a feature shared by other Asian countries over the last year. This continues to place a brake on economic activity. The more recent strength in US$/Yen has exacerbated concerns over Taiwanese export competitiveness vis-a-vis Japan. This raises the possibility of additional trade weighted depreciation in the NT$ while exports remain weak.

TAIWAN: MONEY MARKET AND BALANCE OF PAYMENTS



TAIWAN: MONEY, OUTPUT, GOODS AND ASSET PRICES



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ASIAN MONETARY MONITOR

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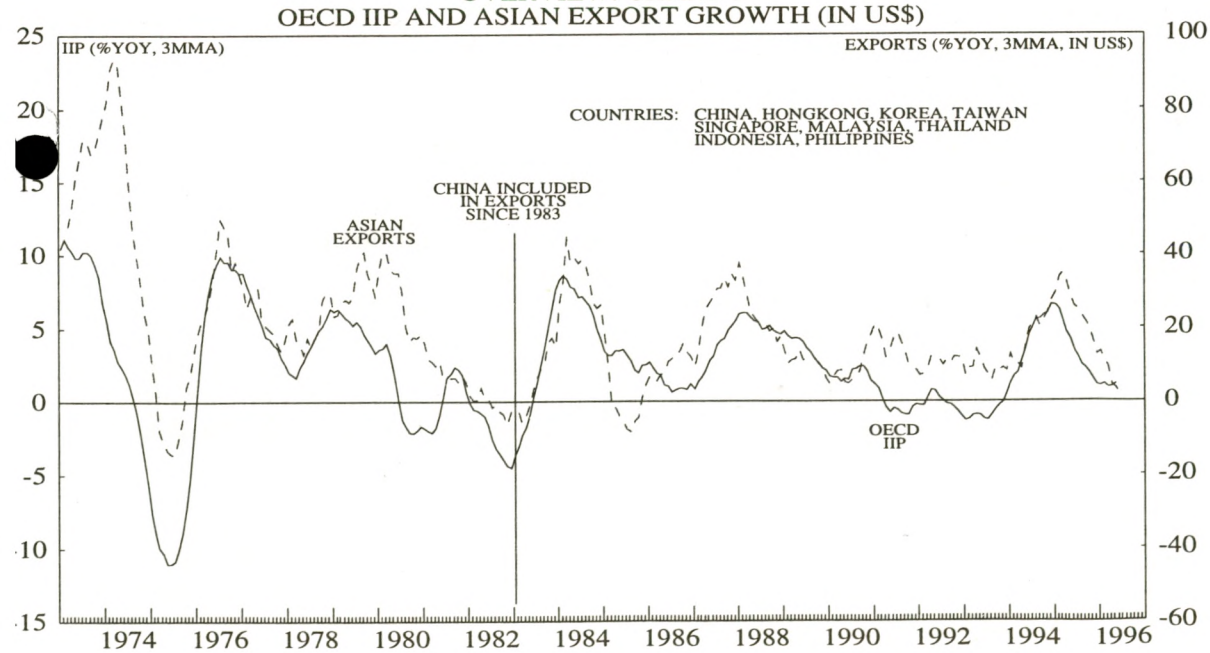
REGIONAL SURVEY
CYCLICAL FACTORS DRIVE ASIAN EXPORT SLOWDOWN

Introduction

This article looks into the causes of the current export slowdown in Asia. Its primary objectives are to dispel the notion that declining competitiveness is the main culprit, and to show that slower export growth, per se, is unlikely to precipitate regional currency or balance of payments crises. While concluding, on this basis, that a recovery in export growth and business activity is due later in 1997 alongside synchronised growth in OECD countries, the article cautions that business activity in 1997 may be muted by comparison with 1994-95, the peak of the export cycle. This is mainly because: (1) the imminent upswing in Asian exports will be tempered by a disflationary bias in both the US and Japan; (2) monetary policies are likely to remain tight in order to suppress the potentially inflationary impact of a huge build up in excess liquidity across the region; and (3) the effects of Yen weakness may yet have a further dampening influence on Asian export growth. In the context of (2), the article suggests that Thailand and, to a lesser degree Malaysia, are most likely to be affected by ongoing disinflationary woes through 1997 as capacity constraints will limit the scope for monetary or fiscal easing. Over the the next two years, efforts to gain tighter control over liquidity growth and inflation, in Asean especially, will prompt a change to more flexible monetary and exchange rate regimes. This will have unequivocally positive consequences for more stable growth across the region, albeit at comparatively lower rates in some countries.

OVERVIEW: CHART 1
OECD IIP AND ASIAN EXPORT GROWTH (IN US$)



Cyclical vs Structural

Economic growth in Asia is set to moderate in 1996 alongside slower export growth. This is much less controversial at present than the factors which lie behind the current Asian export slowdown. From a cylical perspective, the importance of Asia's export links with the OECD is emphasised in Chart 1 on the previous page. Nevertheless, a wide ranging debate has emerged over the role of structural factors in the current slowdown.

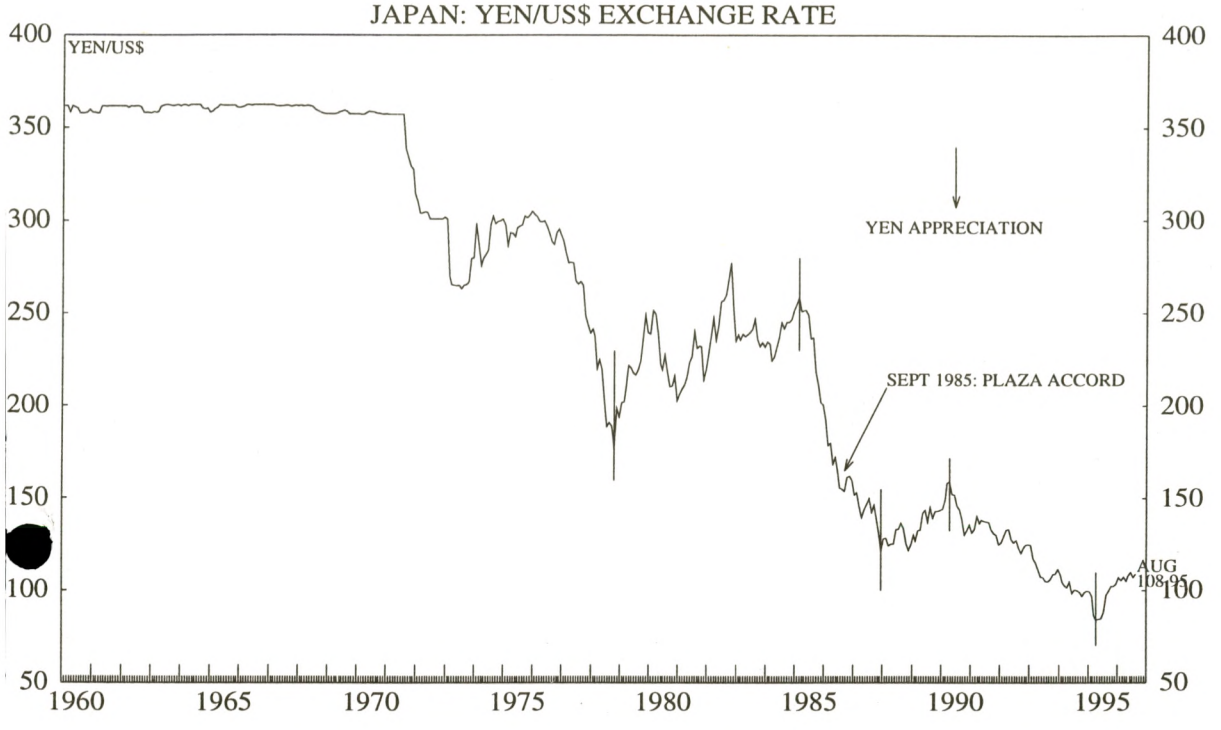
Through the twenty-two year period spanned by Chart 1, four factors stand out as being supportive of Asian export growth. These include: (1) a sustained period of global economic expansion between the 1960s and 1980s, interrupted briefly by global recessions following the oil price shock of 1979 and tight monetary policies in 1982; (2) an outward orientation of economic policy which, inter-alia, places export-led growth and competitiveness as the dominant macroeconomic objective in the region; (3) shifting relative competitiveness in favour of Asia, especially at the expense of Japan; and (4) strong expansion of economic activity within the region itself. In the context of this article, items (3) and (4) are of special interest, primarily because they capture the major forces of structural change influencing the region. From the mid-1980s, the composition of Asian exports has more nearly resembled that of industrial Japan in the 1970s, so that movements of the Japanese currency against the US dollar have played a greater role in influencing export and business activity in the region. Moreover, the change in export product mix within Asia, partly also the result of an appreciating Yen, has reinforced intra-Asian trade and investment linkages between mature and less developed Asian economies.

Cyclical Factors vs Currency Movements

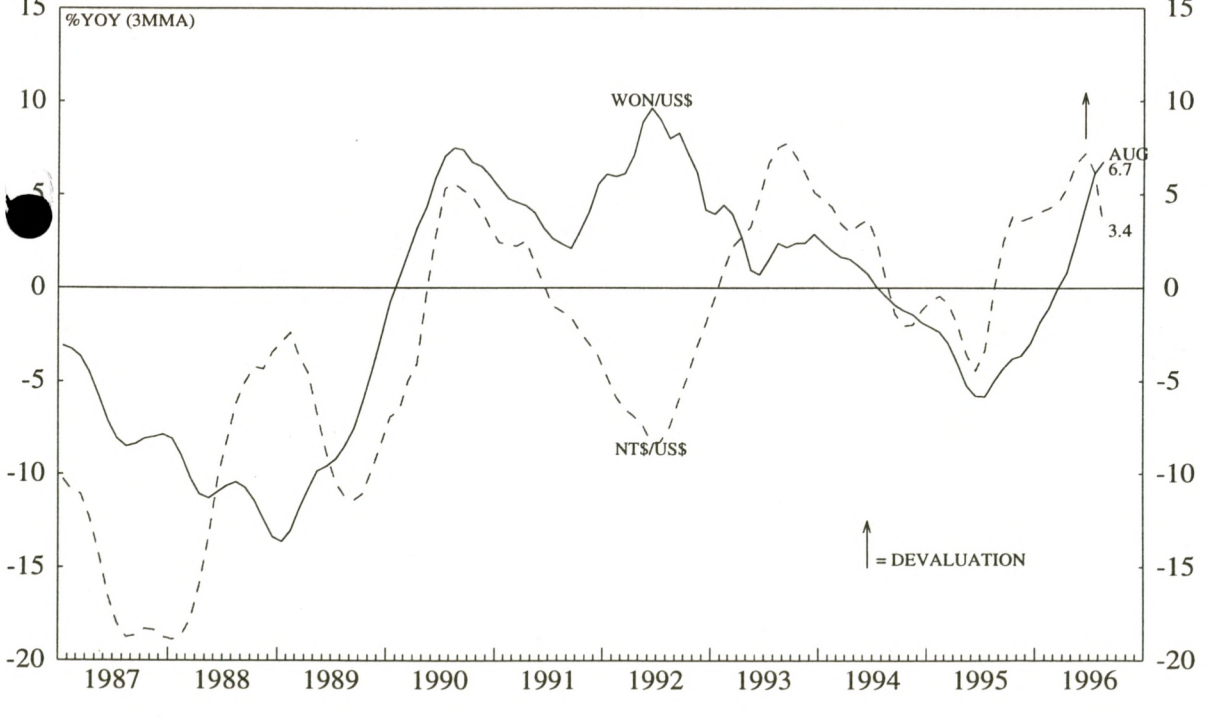
The significance of currency movements to Asian export competitiveness is worth emphasing from a historical context. Chart 1 shows that after an ebb around the end of 1989, exports then proceeded to grow at around 11% YoY between 1990 and 1993, despite a very weak period of industrial growth in the OECD. The steady Yen appreciation against the US dollar throughout this period, shown in Chart 2, coupled with the start of the current Asian investment cycle were obvious sources of support. The sharp acceleration of export activity over 1994 and 1995 came alongside the equally steep recovery in OECD indutrial production. The coincident upswing in Asian export activity and OECD industrial production over 1994/95 was similar to the cyclical pattern observed in 1976/77 and 1983/84, but very different from 1986/87 upturn, where export growth appeared to lead the recovery in OECD countries. Over 1986, the acceleration of export activity was mainly a result of a spectacular fall in the US dollar against the Yen over 1985/86 following the Plaza Accord. This suggests that while the OECD growth cyle is most influential in determining export growth in the region, significant currency movements have supplied a powerful stimulus in the past (n.b. owing to the volatitlity of the US$/Yen exchange rate around an uptrend spanning 1978-85 it is difficult to aportion an exchange rate effect to the fall in export growth between 1980-83, a period which also coincides with weak OECD growth).

What do recent currency movements imply for Asian export growth? The management of Asian exchange rates within narrow bands against the US dollar means that these economies have been subject to a significant shock from 26% Yen depreciation against the US dollar over 1995. The depressing effect of Yen weakness on exports is likely to be felt most in countries competing directly with Japanese products, such as South Korea and

OVERVIEW: CHART 2
JAPAN: YEN/US$ EXCHANGE RATE



OVERVIEW: CHART 3
S. KOREA & TAIWAN: EXCHANGE RATE AGAINST US$



Taiwan. In Chart 3, the tendency for these two countries to defend their export sectors through competitive devaluation is clearly demonstrated during 1996 -- much as in previous periods of Yen weakness. However, for the more rigidly pegged exchange rates such as in Hong Kong and Thailand, the shock to exports is likely to be more severe. For the moment, the substitution effects away from Asian exports resulting from Yen depreciation appear to be limited. Chart 4 shows Japanese imports from Asia have been gaining share although the rate of growth is now decelerating alongside total import growth. Measured from the US, trade data at June 1996 show the US deficit against China, for instance, currently exceeding the US deficit versus Japan. Clearly the "reverse-export" effect (Japanese companies relocating to Asia and exporting back to Japan) deriving from the prolonged period of Yen strength between 1990 and 1995 is continuing to benefit Asian market share in Japan. Thus, while it may be argued that the full adjustment of Asian exports to Yen weakness is yet to be felt, equally the positive effects from ongoing "hollowing out" of Japanese industry may well continue to offset this factor . On balance, the conclusion from recent developments must be that Yen weakness has been neither sufficient, nor prolonged enough from a historical perspective to have a lasting impact on Asian export competitiveness.

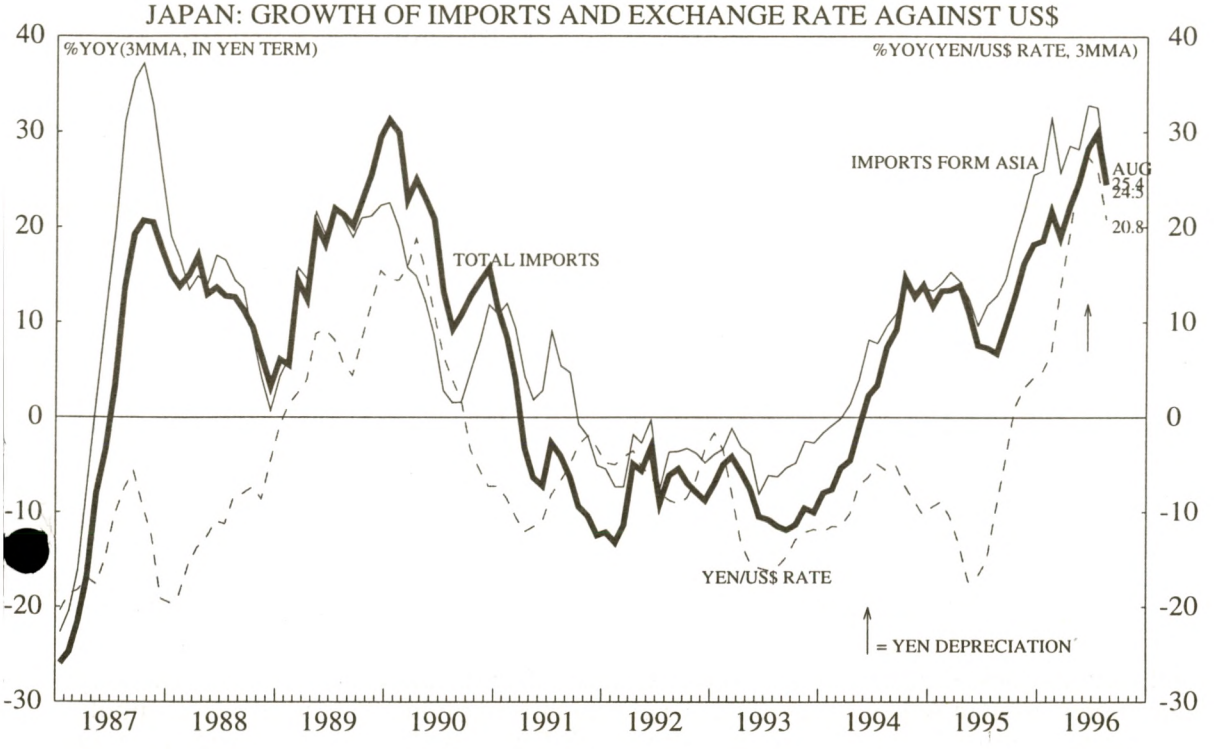
Aspects of Intra-Asian Trade

The problems with dwindling competitiveness of Japanese industry run deeper than simply an appreciating Yen, suggesting that Asia has remained an attractive place in its own right for Japanese industry to invest and export from. This is partly borne out by Chart 5 which shows Asia gaining global export share at the expense of industrialsed countries. The relocation of Japanese industries to lower cost bases is a major factor supporting this trend but the rapid expansion of intra-Asian trade (excluding Japan) shown in Chart 6 has been equally important. Intra-Asian exports accounted for 40% of total Asian exports at the peak of the cycle in 1995, compared with 32% in 1988. The substantial relocation of industries within Asia as more mature economies shed labour intensive processes to less developed regions is contributing strongly to intra-Asian trade. For instance, re-exports to China from Hong Kong account for almost 80 % of Hong Kong's total exports . Similarly substantial trade between Malaysia and Singapore is linked to the outprocessing of manufacturing activity. The second, more general, aspect of intra-Asian trade is that it reflects the rapid economic development of the region as a whole and better distribution networks which characterise that development. The third factor contributing to growth in intra-Asian trade has been the push to lower tariffs typified by initiatives to form an Asean Free Trade Area by 2003. Although trade amongst Asian countries is an obviously positive contribution to Asian export activity when global demand is strong, it will also tend to reinforce the cyclical downswing in export activity when OECD demand is slack . This is demonstrated by the sharp dip in intra-Asian exports during 1993 shown in Chart 6.

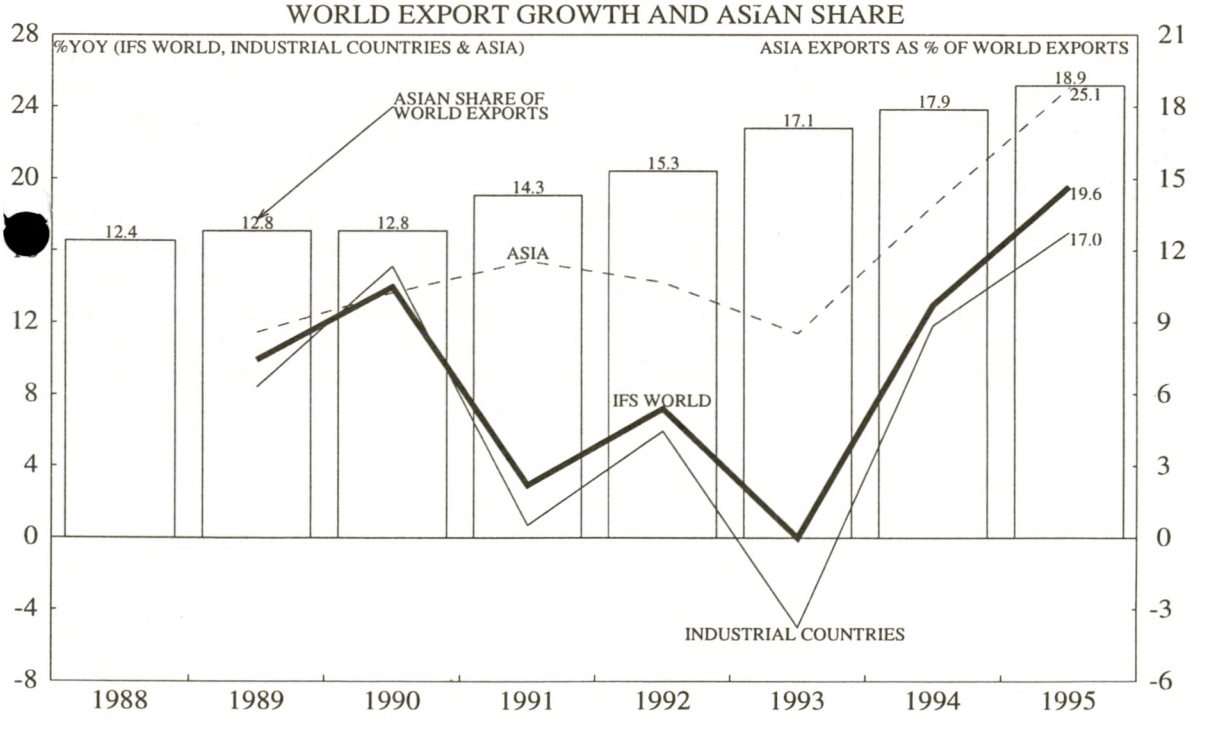
Ongoing Competitiveness

Does Asia remain a competitive place to invest? Chart 1 showed Asian exporters enjoying a massive boom in 1987-88. That upswing was assisted by a sizeable boost to competitiveness delivered by the Plaza Accord of 1985 which succeeded in substantially weakening the US dollar. Chart 7 shows that only some 15% of competitiveness gained since 1988 has been surrendered, measured by the upward drift of respective exchange rate indices. Real exchange rate appreciation is in itself a long-term cyclical phenomenon capturing changes in the productivity cycle over time. Thus, it is natural to expect in Thailand and Malaysia, for instance, that real exchange rate appreciation is reflecting attempts to shift into higher-value-added processes, which inevitably take time as education levels

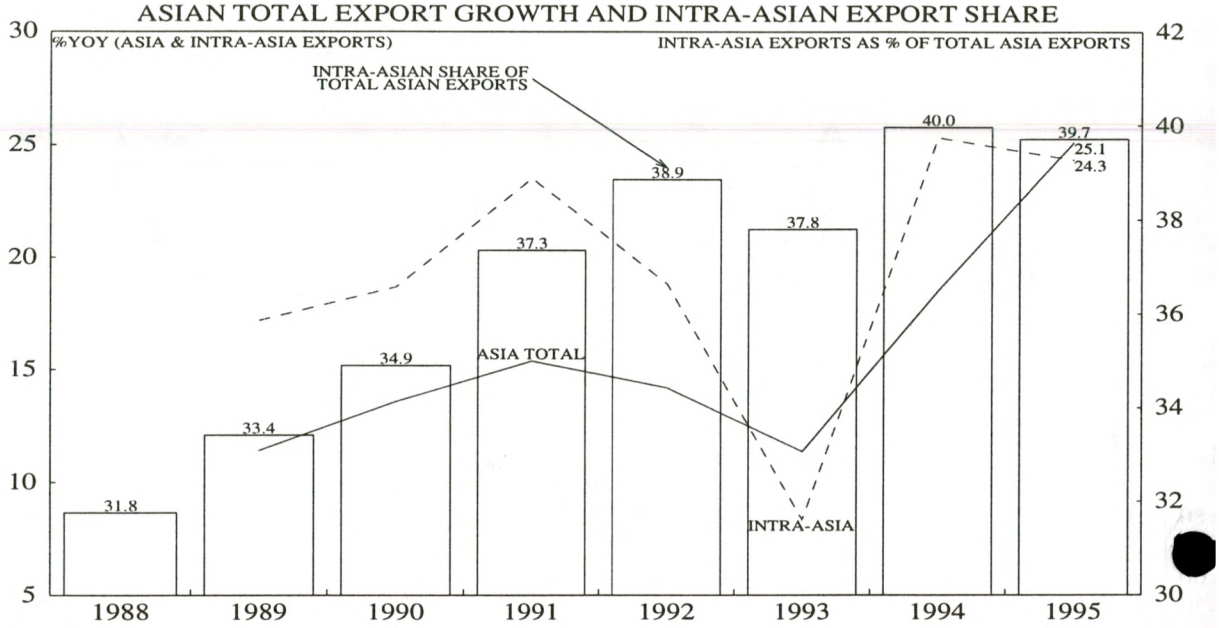
OVERVIEW: CHART 4
JAPAN: GROWTH OF IMPORTS AND EXCHANGE RATE AGAINST US$



OVERVIEW: CHART 5
WORLD EXPORT GROWTH AND ASIAN SHARE



OVERVIEW: CHART 6
ASIAN TOTAL EXPORT GROWTH AND INTRA-ASIAN EXPORT SHARE



and technologies improve. However, the indices in Chart 7 also show that real exchange rate appreciation in Asia is proceeding at a glacial rate, implying that the negative stimulus to exports over the the past decade has been small. This provides more evidence that Asian exports as a whole remain competitive and far more sensitive to OECD demand.

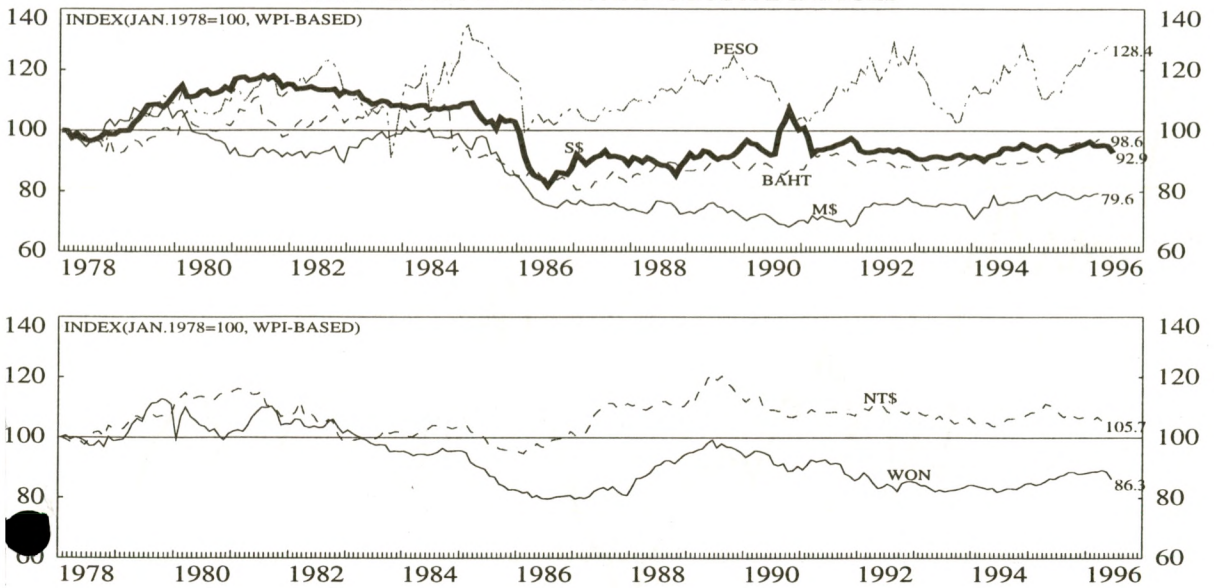
The Electronics Cycle

A second shock to Asian exports over the past twelve months has been the sharp correction in prices of computer chips and electronic components. Export prices generally reflect external demand factors through a normal cycle but the downward correction in DRAM chip prices, by some 75% in the year to June 1996, was both unexpected and abrupt. Electronics related products account for between thirty and fifty five percent of exports in major exporting nations in Asia. While, this factor is more significant in the context of South Korea and Taiwan, the major "chip" producers of the region, Chart 8 shows the extent to which exports in Singapore (like Asean generally) are driven by the wider electronic products cycle. A recovery of electronics exports can be expected together with a general upturn in export demand. However, despite a recovery in volume growth, electronic goods prices will probably remain subdued by the build-up in component inventories, in major exporters such as South Korea.

The Monetary Implications in Asean

In most Asian countries, the export slowdown will have direct monetary consequences in terms of an equivalent deceleration of the domestic money supply. The slowdown in export growth will also expose to a greater degree the steady deterioration in trade and current account deficits across the region since 1990. This is likely to be especially true Asean, where deterioration of the collective current account deficit shown in Chart 9 reflects developments mainly in Malaysia and Thailand. In contrast to previous cycles, the export boom in Asean between 1993 and 1995 was accompanied by even more robust expansion in domestic demand and import growth. The latter has been accentuated by

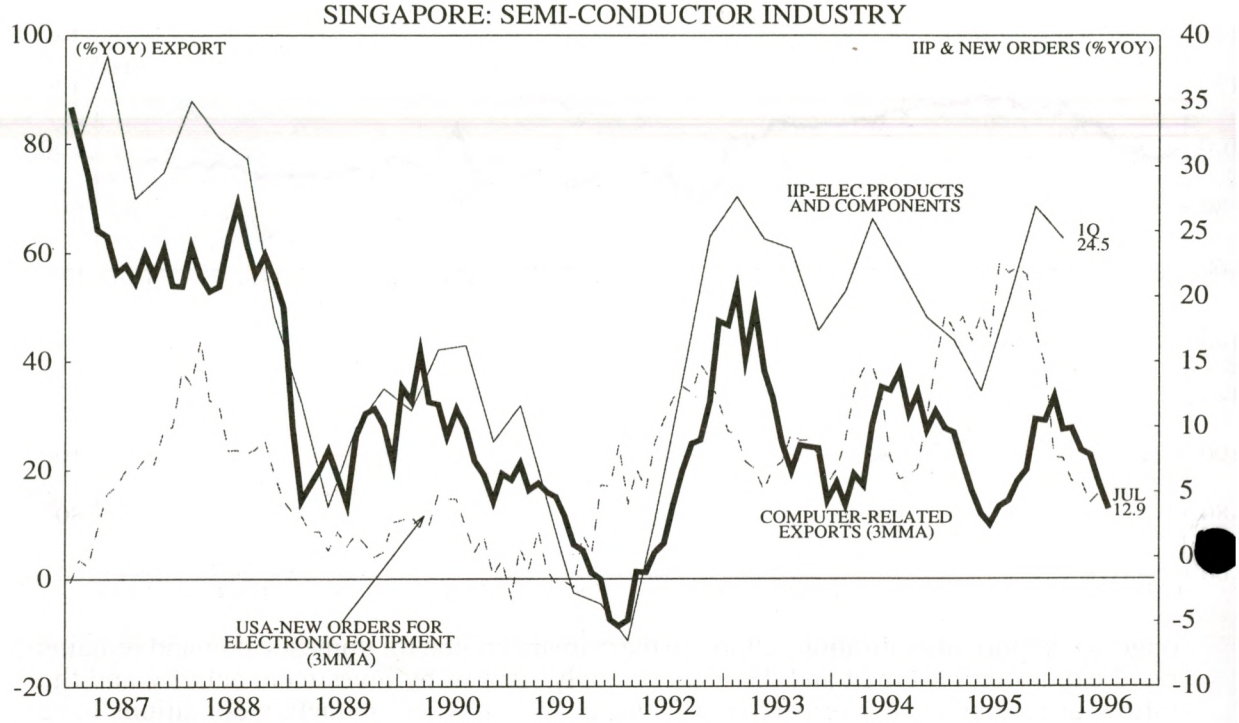
OVERVIEW: CHART 7
REAL EFFECTIVE EXCHANGE RATE INDICES



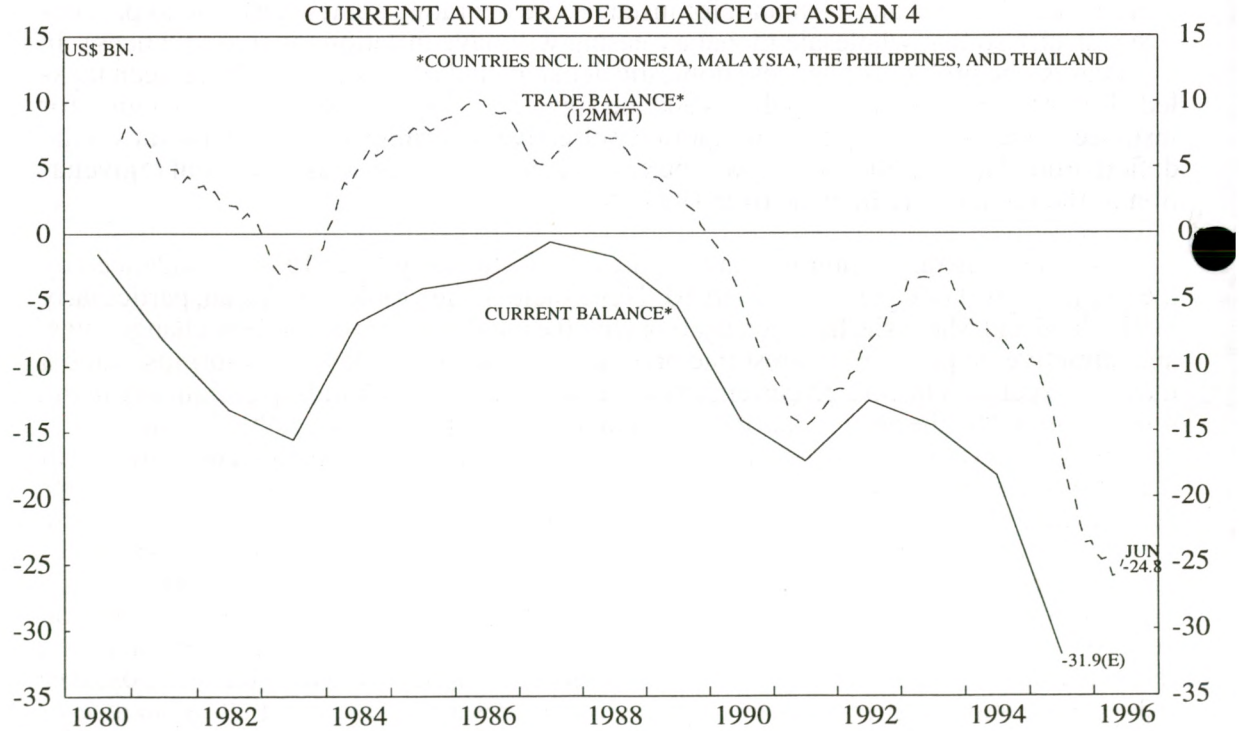
ongoing import liberalisation, although the primary engine for domestic demand remains rapid expansion of credit and the money supply, driven by investment activity and the inflow of foreign capital respectively. Thus, in Asean, where monetary conditions have been tight for the past year at least, the delicate balance between easing credit to exporters and other weak sectors of the economy, while maintaining a tight rein on overall credit expansion, remains a challenge for policy makers (implicit within this statement is the notion that Malaysia and Thailand, for instance, are operating somewhat close to productive capacity so that wholesale monetary easing will have inflationary consequences). In most cases, the problems of excess domestic demand, and import growth, have been tackled through micro-economic policies and the application of moral suasion -- the latter, for instance, which is proving to be temporarily effective in turning around Malaysia's trade deficit. Equally, any policy easing will be gradual and piecemeal so as to prevent rejuvenation of the rampant credit cycle over 1994/95 .

Asean monetary conditions have tightened substantially since 1994 as evidenced by the rise in interest rate premia in Chart 10. Nevertheless, the problem in Asean, particularly in Thailand and Malaysia, has been dealing with the consequences of stable exchange rates, and attractive (ie positive) interest rate premia: large balance of payments surpluses and a massive expansion in foreign currency reserves since 1990. The build-up of liquidity in the region implied by the accumulation of foreign reserves is partly responsible for the steady diminution in average interest rate premia since 1990, despite the marked deterioration in the current account deficits. Chart 10 shows that the combination of these liquidity supportive factors is preventing interest rate premia from rising above 6% in the current cycle especially during 1996. However, the level of reserves is an important barometer of investor confidence in domestic macro-economic management . Witness how interest rate premia in Chart 10 rose much more abruptly over the previous cycle of trade balance deterioration between 1981 to 1985 (albeit from negative territory), at a time when reserves stocks were relatively modest. The increased investor confidence implied by lower (but still positive) risk premia, and a higher stock of foreign currency reserves, suggests that a balance of payments or currency crisis is not imminent; even as capital inflows moderate over the coming months.

OVERVIEW: CHART 8
SINGAPORE: SEMI-CONDUCTOR INDUSTRY

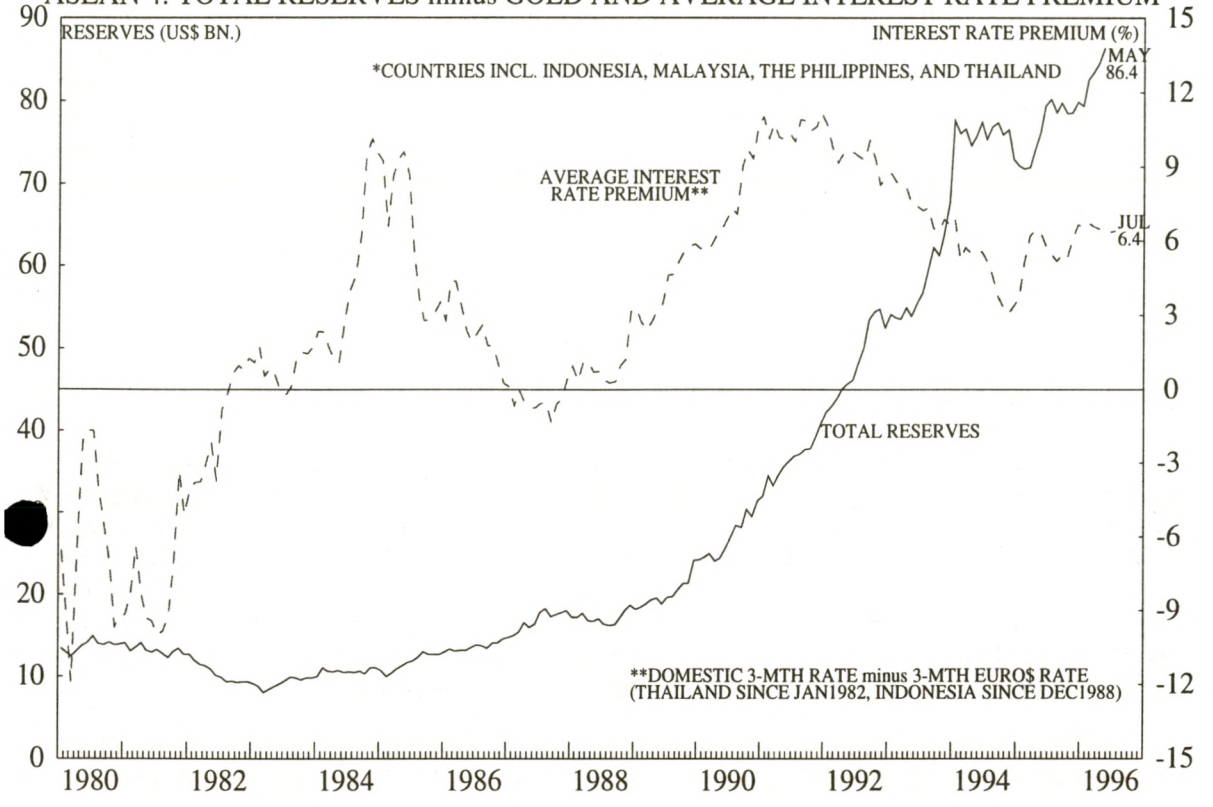


OVERVIEW: CHART 9
CURRENT AND TRADE BALANCE OF ASEAN 4



OVERVIEW: CHART 10

ASEAN 4: TOTAL RESERVES minus GOLD AND AVERAGE INTEREST RATE PREMIUM



However, the counterpart to unsterilised reserves accumulation is growth in the domestic money supply. There remains, therefore, certain risk of perceived "policy inconsistency" if interest rate premia are allowed to sink too low while the symptoms of overheating loom large. As we forecast in this publication early in 1995, following the Mexican crisis (see AMM Vol 19 No.1), the currency markets are scouring the region once again to exploit inconsistencies which may have arisen following a prolonged period of monetary tightening, since 1994 in some cases (readers may recall how calls for lower UK interest rates in September 1992, in the midst of recession, eventually precipitated massive speculative attacks on the UK currency within the European Exchange Rate Mechanism). In this vein, there is plenty of currency market interest and concern currently focused on economic and political developments in Thailand and to a lesser degree Malaysia although neither currency appears overvalued on a real exchange rate measure (for a review of the current Thai exchange rate dilemma see AMM Vol 20 No. 3).

Import growth in Asean will naturally decelerate alongside export activity, and in response to policy measures aimed at curbing domestic demand. Moreover, money supply and credit growth are also showing signs of easing as capital inflows gently abate. Thus while lower risk premia may be temporarily justified, central bankers will probably wish to prevent much further substantial diminution in interest rate premia while current account deficits remain wide. This threat, from sudden flight of capital amid narrowing interest rate premia, is probably sufficient to ensure that monetary conditions ease only slightly in Asean over the coming year, despite the economic drag from slowing exports.

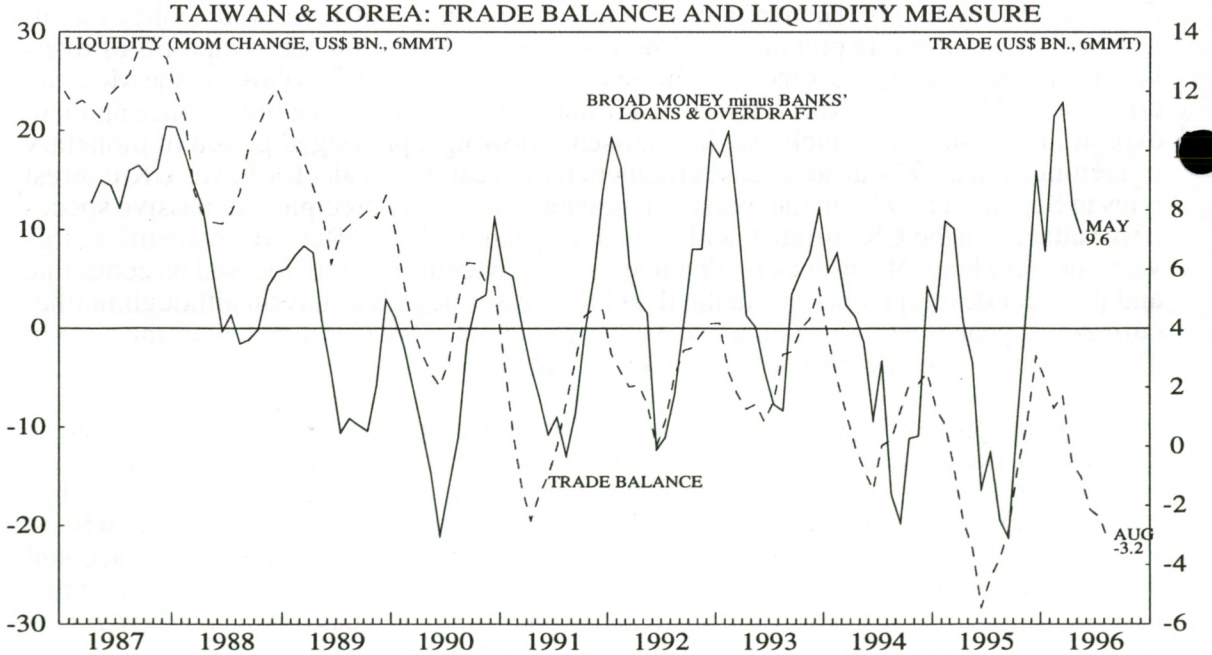
The lesson for the future and implications for the business cycle are relatively clear. They stem from the recognition that disinflation requires a change in monetary policy, whereas stabilisation (moving from one stable equilbrium to another) requires a change in monetary regime. Thus moves to greater currency flexibility are already gaining momentum. Indonesia has widened its currency fluctuation band three times since August 1995 under the weight of capital inflows. The Malaysian Ringgit has appreciated steadily through early 1996 in response to capital inflows. It remains perhaps for Thailand to consider widening its currency fluctuation band at a more appropriate time in the cycle (see AMM Vol. 20 No.3). Greater currency fluctuation will naturally impart a dis-inflationary bias to the business cycle over the long-term as capital inflows will tend to appreciate the nominal exchange rate. However, the experience of Indonesia (with managed depreciation) and Singapore (with free float) suggests that greater flexibility can deliver an entirely satisfactory outcome in dealing with inflation, without disastrous consequences for growth.

Liquidity in the North

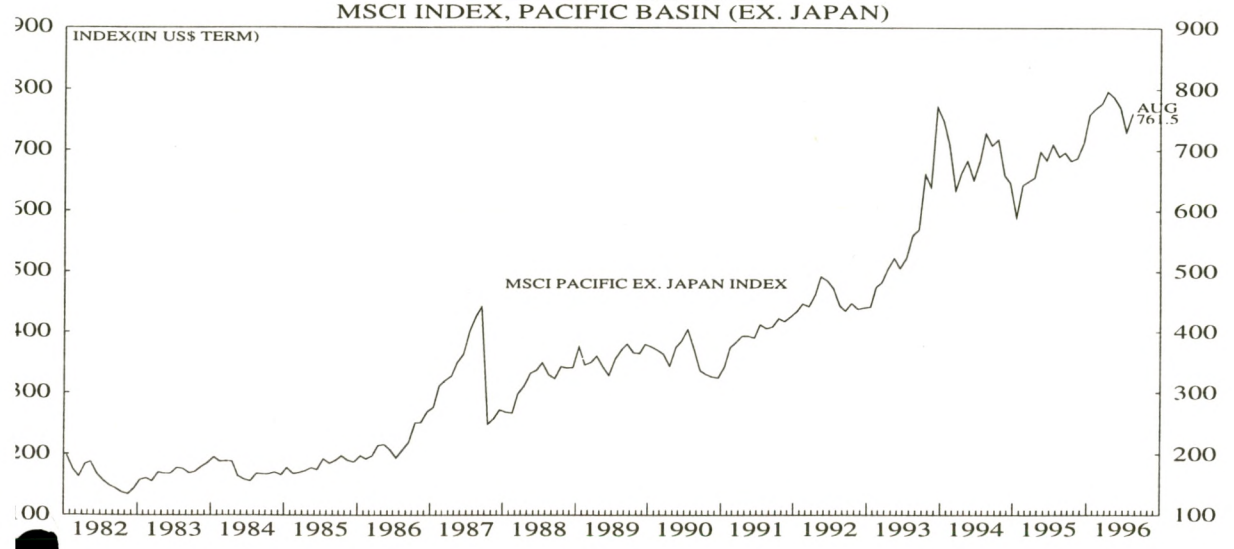
The huge excess of money supply generated from capital inflows in Asean means that net export activity there is a marginal determinant of liquidity. The same, however, cannot be said for the relatively closed North Asian economies of Korea and Taiwan. Chart 11 shows clearly how trends in the trade accounts of Korea and Taiwan dominate financial sector liquidity with a lag of around six months. The collapse in the combined trade balance over 1996 emphasises not only the extent to which exports in Taiwan and Korea have been affected by cyclical factors discussed in this article, but also how financial sector liquidity is likely to be depressed (in Korea mainly) by the rapidly widening trade deficits.

Pacific Basin (ex-Japan) markets of the region extended their gains over the first half of 1996 (see Chart 12) but subsequently entered a period of consolidation and, in some cases, minor correction. The collection of increasingly bleak export numbers published over 1996 is one factor leading the consolidation as financial markets generally revise

OVERVIEW: CHART 11
TAIWAN & KOREA: TRADE BALANCE AND LIQUIDITY MEASURE



OVERVIEW: CHART 12
MSCI INDEX, PACIFIC BASIN (EX. JAPAN)



down their economic growth expectations for 1996 and 1997. Even in the Philippines, where market performance has been the best in the region (outside China) over 1996, and export growth relatively robust, the market is having difficulty making progress in 1996H2. In addition to growth and earnings concerns, particularly in markets with large electronics sectors, capital outflows and technical factors have further dampened investor interest. Financial markets in Asia are likely to remain generally subdued through 1996 and early 1997 while the propects for regional exports remain lacklustre and tight monetary conditions prevail in certain countries. However, there is likely to be some anticipation by the end of 1996 of better export and earnings performance alongside OECD recovery during 1997. This should present a generally more favourable environment for Asian stockmarkets moving into the new year.

SUMMARY AND CONCLUSIONS: The business expansion in Asia is set to moderate over the coming year as export growth, the main engine for economic activity in the region, remains subdued. The bulk of economic evidence favours cyclical over structural factors as driving the current export slowdown. This means that export growth will recover in line with stronger economic actvity in the OECD by mid-1997; although the persistence of dis-inflationary forces in the OECD means that the export upturn may not be spectacular as in 1994 and 1995.While the export slowdown will expose trend deterioration in regional trade deficits to an even greater degree, financial markets perceive little risk of balance of payments or currency crises in the major economies. Nevertheless, the problems in dealing with the earlier build-up of excess liquidity in Asean, coupled with the capacity constraints in certain economies, will have two important consequences: (1) monetary conditions will ease only gradually over 1997; and (2) monetary policy regimes in Asean are likely to be modified over the next two years to accommodate greater flexibility. Regional stockmarkets entered a period of consolidation in 1996H2 as economic growth expectations are generally revised downwards. Uncertainties over the direction, timing, and extent of US interest moves, and the time profile for domestic monetary easing, is also dampening foreign investor sentiment. Stockmarkets in Asia are likely to remain subdued, perhaps until late 1996 or early 1997, when meaningful prospects for an improvement in both regional export growth, and trade balances, are likely to be perceived. The return of better sentiment by the new year should, particularly in Asean, coincide with a period of better of domestic liquidity as economic growth in the region reaches a cyclical ebb.

AUSTRALIA
ADJUSTING TO LOWER INFLATION

Introduction

Historically, Australian bonds have commanded a higher yield over US treasuries to compensate holders for a higher inflation risk. In recent years this has contracted for two reasons. First, like most of the OECD, Australia has experienced persistently lower rates of inflation since the early 1990s than in the 1980s. Second, it is possible to detect some reduction in inflation expectations. This may be due, in part, to a degree of improvement in the perceived credibility of the Reserve Bank of Australia (RBA) in pursuing anti-inflationary monetary policies.

The lower inflationary environment in Australia since 1992 has encouraged prolonged bond market rallies and a narrowing in the yield spread over their US counterparts. With the exception of the knee-jerk reaction in 1994, this has resulted in an almost persistent flattening in the Australian yield curve. While local banks had participated in some of the previous bond rallies, the bulk of the support came from overseas investors. This has contributed to some A$/US$ appreciation in the last 18 months and also to some expansion in total A$ deposits and lending within the banking system.

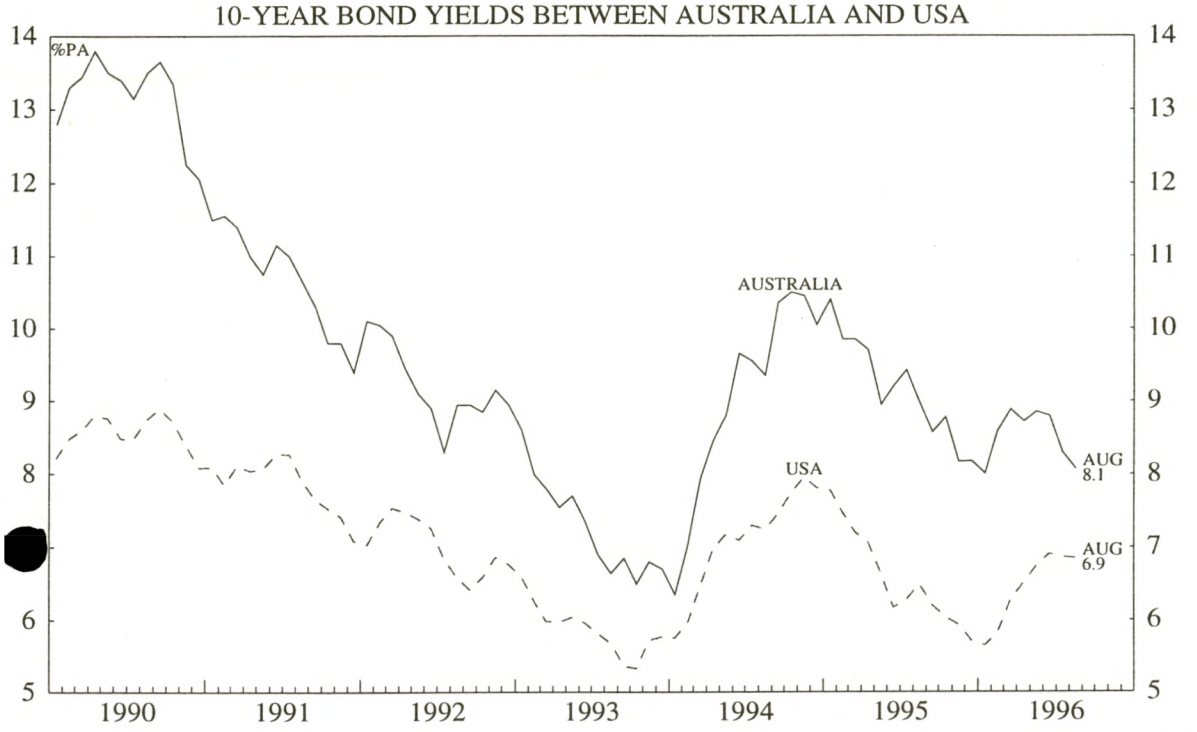
The inflow of foreign capital has driven down bond yields, but this has not led to easier monetary conditions over the last two years. Developments in the real economy have been more sensitive to moves in short term interest rates. In particular, the economy is in the midst of a correction which originates from the series of interest rate rises made by the RBA in 1994. Notwithstanding the overall tightening in monetary policy in 1994, the demand for credit at prevailing interest rates has remained strong and banks have not met a serious balance sheet constraint yet. One qualitative change regarding this credit cycle relates to the rise in non-bank lending particularly in mortgage origination which remains strong in the wake of the monetary tightening. Because the interest rate rises of 1994 have not bitten as hard as those in 1988, the current economic slowdown will not be as prolonged as in the previous one and so the economy should recover over the course of 1997. The timing of this economic recovery could well be brought forward by the recent interest rate cut, especially if it is followed by another one in the near future.

A lower Inflation Environment

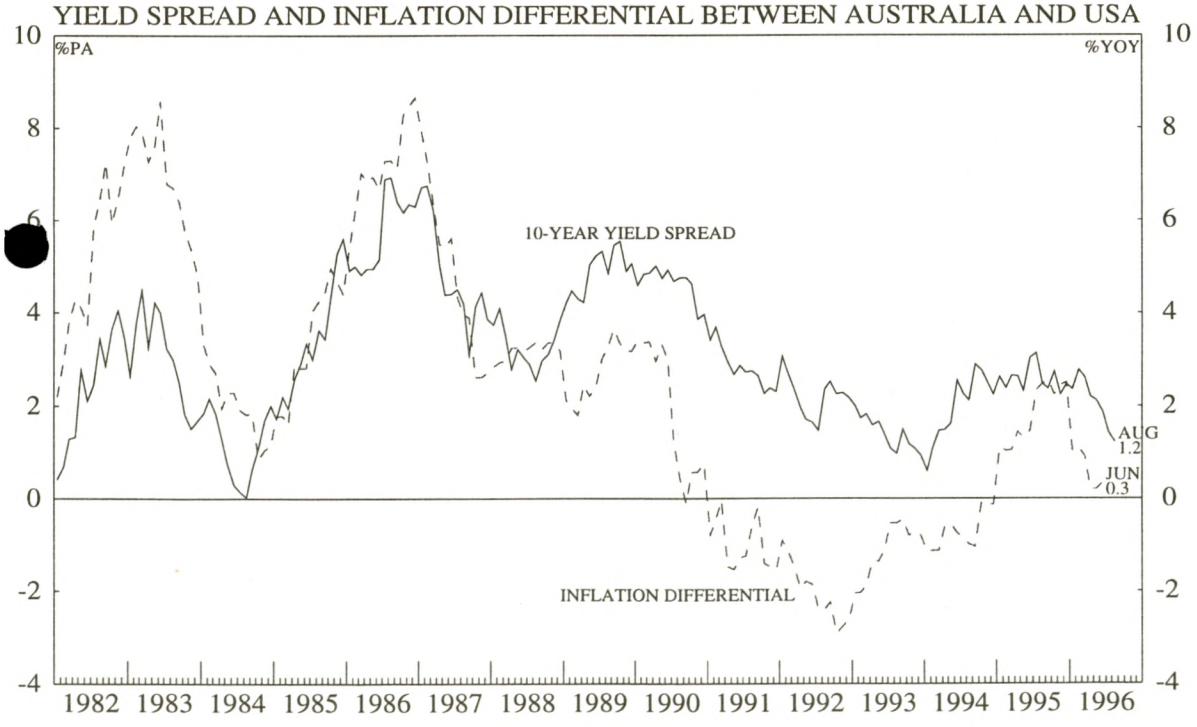
The ability of the RBA to keep inflation low and subdued since 1990 has led to renewed declines in Australian bond yields (chart 1). At the same time there has been a narrowing in the spread between bond yields in Australia and those in the US since 1990 (chart 2). One can infer from this that the variation in the expected rate of future inflation in Australia has declined and become more 'in tune' with that in the US. Moreover, the anti-inflationary attitude and vigilance over future inflation adopted by the RBA in Australia has improved and is more akin to that of the Fed in the US.

Despite this, the narrowing in bond market spreads has not been smooth and uninterrupted. In 1994, Australian yields jumped up by more than those in the US as bond markets reacted to the inflationary consequences of the pick up in economic growth. This had occurred in previous bond market sell-offs in 1985 and 1988. The expansion in economic growth that was developing in the US and Australia in 1994 prompted a speculative surge in commodity prices and a rise in the A$/US$. However, this was followed by a correction in economic growth which began in 1995 in the wake of the RBA's tighter monetary policy.

AUSTRALIA: CHART 1
10-YEAR BOND YIELDS BETWEEN AUSTRALIA AND USA



AUSTRALIA: CHART 2
YIELD SPREAD AND INFLATION DIFFERENTIAL BETWEEN AUSTRALIA AND USA



The absence of a synchronised upswing in OECD economic growth and persistence of relatively low inflation conditions has led bond market participants to feel more confident that the current cycle in Australian economic growth and inflation will be more muted. Consequently, the bond spread has contracted further and is now reapproaching its 1993 lows.

The possibility for future declines in Australian long bond yields depends on the extent to which inflation expectations have improved. These can be measured in two ways. One method involves direct measurement of expectations by collecting data from questionnaires regarding private sector views about future inflation. The second method is more indirect and relies on the calculation of inflation expectations using nominal bond yields and CPI-index linked bond yields. The Commonwealth government of Australia has been issuing index linked bonds since the mid-1980s. The number of outstanding issues has increased through the 1990s to around $1.5bn today (around 2% of total stock of commonwealth bonds on issue). Although market turnover has expanded over the years the market is not as deep as that in the UK.

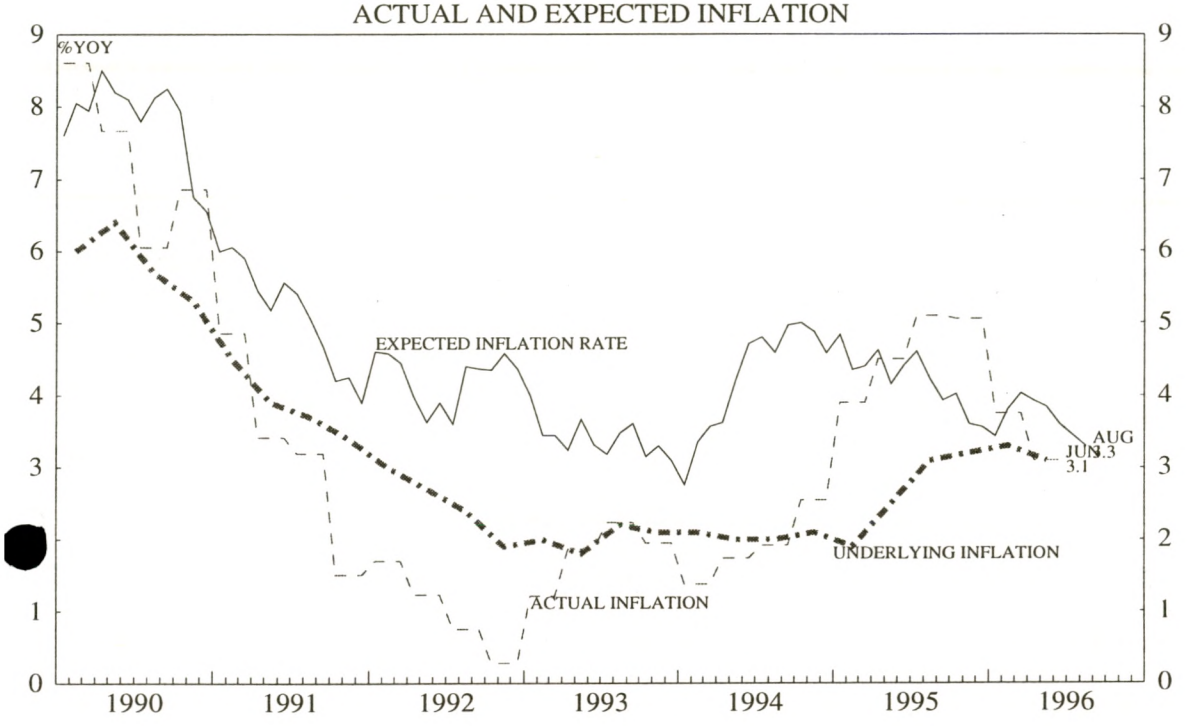
Notwithstanding the potential liquidity problems, for recent years index linked bond yields may be useful in gauging the direction of inflation expectations. A measure of the expected inflation rate can be calculated by constructing a zero coupon forward rate curve and subtracting from this an equivalent index linked forward rate curve. This then gives a term structure of inflation expectations plus an inflation risk premium. Chart 3 shows a crude gauge of this for the long end of the curve only. It plots the historic difference between the 10 year nominal yield and the index linked yield of maturities 10 years and above. It ignores the zero coupon effect and indicates the expected inflation rate at the long end, plus an inflation risk premium.

One can see that the expected measure of the inflation rate exceeds both the actual CPI measure and the treasury's underlying rate for most of the time since 1990. However the shortcomings of this crude measure make it difficult to be too precise about measuring the gap between these two rates of inflation. One can observe that the expected inflation rate has declined in line with the actual rates over the last 5 years. As one might have expected, the economic growth scare in 1994 which led to a back up in bond yields, also raised the expected inflation rate. However, since mid-1995 the expected rate of inflation has been coming down, despite the modest acceleration in the underlying inflation rate. These trends have produced a narrowing in the differential between the actual and expected inflation rates. This signifies a reduction in the inflation rate premium and reflects a degree of improvement in the market perception of the RBA's counter-inflation policies. The implication of this move is that real long term interest rates have taken a longer term step down and that the recent contraction in the Australian yield spread over US treasuries is a longer term feature (charts 2 and 4).

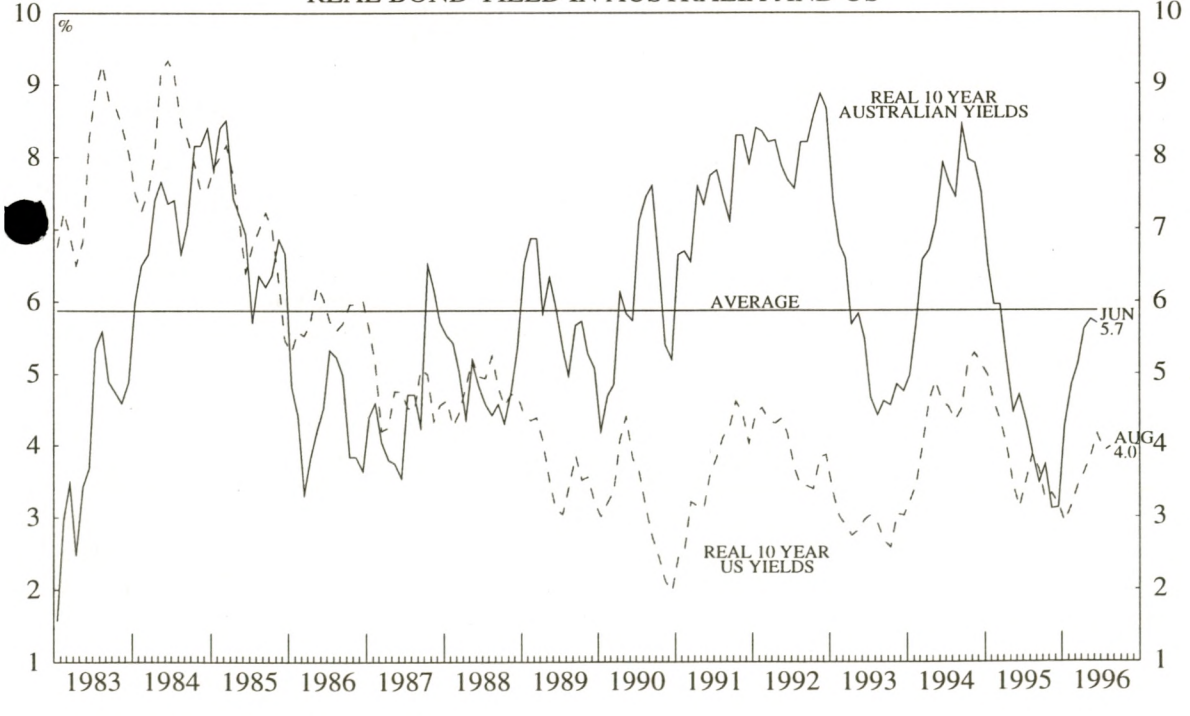
Flatter yield curve and Balance Sheet trends

The transition to a lower inflation environment has meant that a lower level of inflation has been built into the longer end of the yield curve. Consequently, the yield curve has had a tendency to flatten over the last few years, with the exception of the 1994 sell-off (chart 5). The rise in short term rates in 1994 was unlike that in 1985 or 1988/89 in that it was preceded by a rise in long rates. As a result, the yield curve actually steepened during the time that the RBA was tightening monetary policy rather than inverting as in the previous cycles. In contrast with the inverted yield curve in 1988, after the monetary tightening in 1994, the yield curve flattened (but remained positive) due to the decline in long bond

AUSTRALIA: CHART 3
ACTUAL AND EXPECTED INFLATION



AUSTRALIA: CHART 4
REAL BOND YIELD IN AUSTRALIA AND US



yields. The persistence of a flattening, positive yield curve since 1994 implies that the negative impact of the monetary tightening on credit will likely be less than that in previous cycles. In addition, as a predictor of future real GDP growth, the recent stability in the yield curve augurs for a modest and stable recovery in real GDP growth over the next 12-24 months.

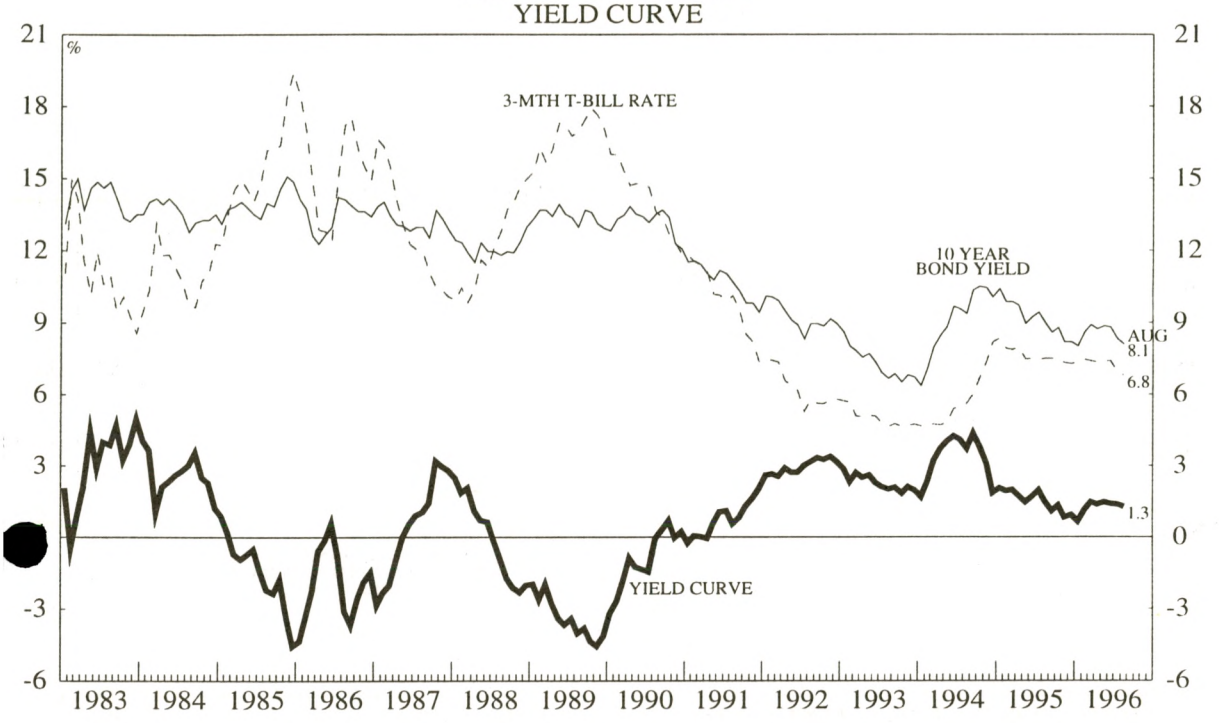
The trends in credit growth are consistent with the more stable positive yield curve during the recent monetary tightening. Bank credit growth accelerated almost uninterrupted since 1992 to reach a pause in 1994-95, before resuming an uptrend over the last year (chart 6). Credit extended by all financial intermediaries has followed a similar trend. Hence the series of rises in short term interest rates in 1994 brought about a pause in a generalised uptrend in credit growth. The short rate increases were insufficient to invert the yield curve and bring about a reversal in the direction of credit growth. Despite the tighter monetary policy post-1994, the demand for credit remained relatively firm at the prevailing interest rates even though the ongoing uptrend has been more subdued than the credit expansions of the 1980s.

This is supported by trends in loans-to-deposits ratios. Looking at banks balance sheets alone one can see that they have become more extended over the past 2 years (chart 7). This followed on from a period of more modest loan expansion in 1992-93 when some banks and non-bank financial intermediaries were still repairing their balance sheets. Adding back the non-bank financial sector gives a similar picture. Balance sheets across the non-bank sector were damaged severely after the monetary tightening in the late 1980s. However, from 1993 onwards this sector has been able to increase its degree of leverage as measured by credit to deposit type ratios. A consolidated measure of loans to deposits is shown in chart 7. It indicates that financial intermediaries as a whole are more sensitive to changes in short rates now than even a year ago.

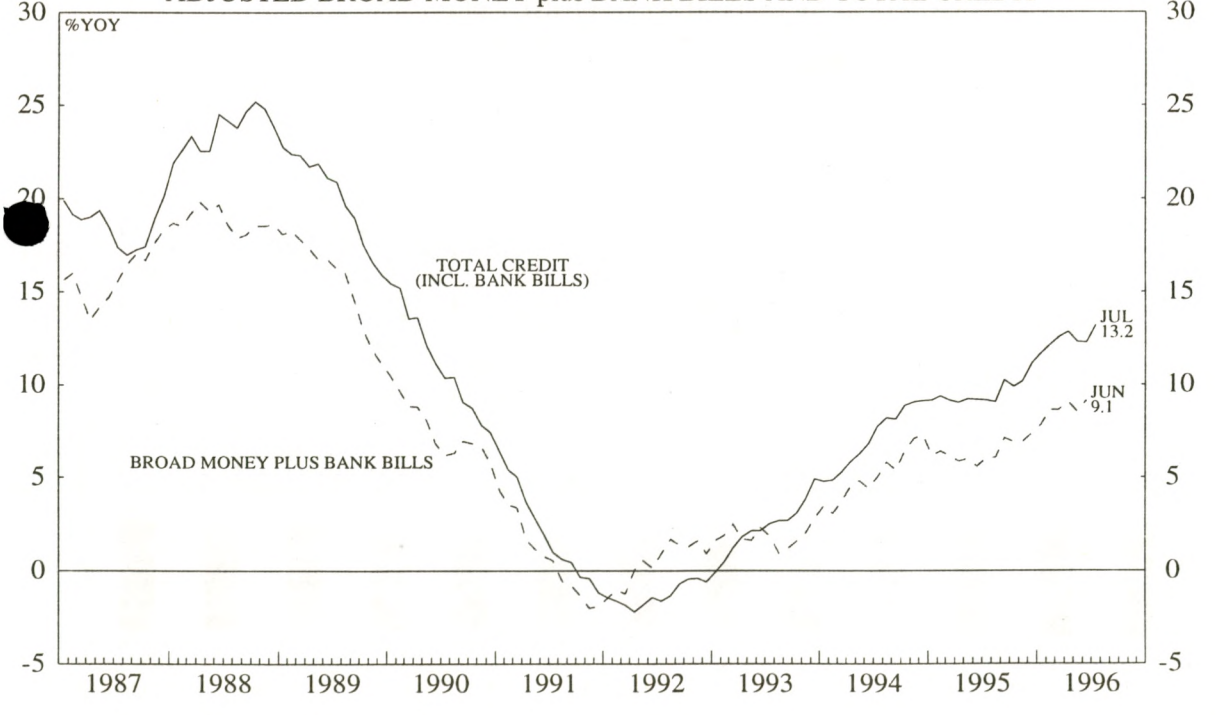
One qualitative change within the banking system which bears out these trends is the emergence of non-bank mortgage 'originators' (or managers). These mortgage 'originators' lend out mortgages and finance this by issuing mortgage backed securities. The mortgage backed securities are then sold on to wholesale investors. With no branch network they save on the cost of this overhead. However, without access to low cost current account-type funds, which are available to the banks, their average cost of funds is higher as they rely on the wholesale markets. The other financial institutions who buy these loans bear the risks as the mortgage managers do not hold housing loans on their own balance sheets. Unsurprisingly, the margins of banks in this area have diminished as variable mortgage rates have come down from 3%+ to around 2.25% over 3 month interest rates. This process looks likely to continue as mortgage managers raise funds at a cost of 40-50 basis points above the 3 month rate and typically charge a margin 1.2-1.5% over this. Over the past year the mortgage managers have eroded some of the banks' market share, but these changes will take longer before we see a significant impact on the total stock of outstanding loans. At present new finance commitments for owner occupied housing by mortgage managers account for around 5% of total housing finance commitments for owner occupied housing. Nevertheless the fresh competition is encouraging banks to offer 'honeymoon' rates for first time buyers and increase the number of mortgage refinancings. In addition, the more stable low inflation environment is prompting banks to offer a greater number of loans at a fixed rate for two years or more.

Despite the recent growth in non-bank house financing, non-bank credit to the private sector as a share of total financial intermediary assets has not improved significantly in the last couple of years. It remains between 23- 25%, around 10% lower than the share in

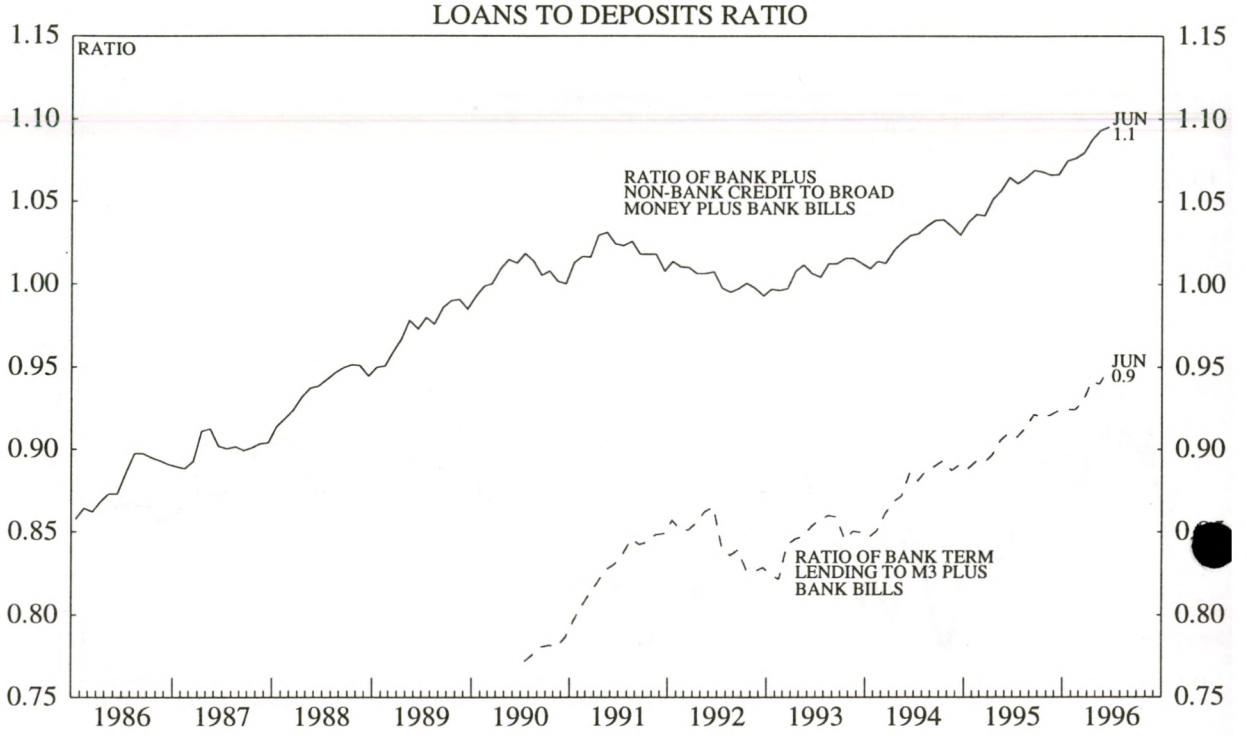
AUSTRALIA: CHART 5
YIELD CURVE



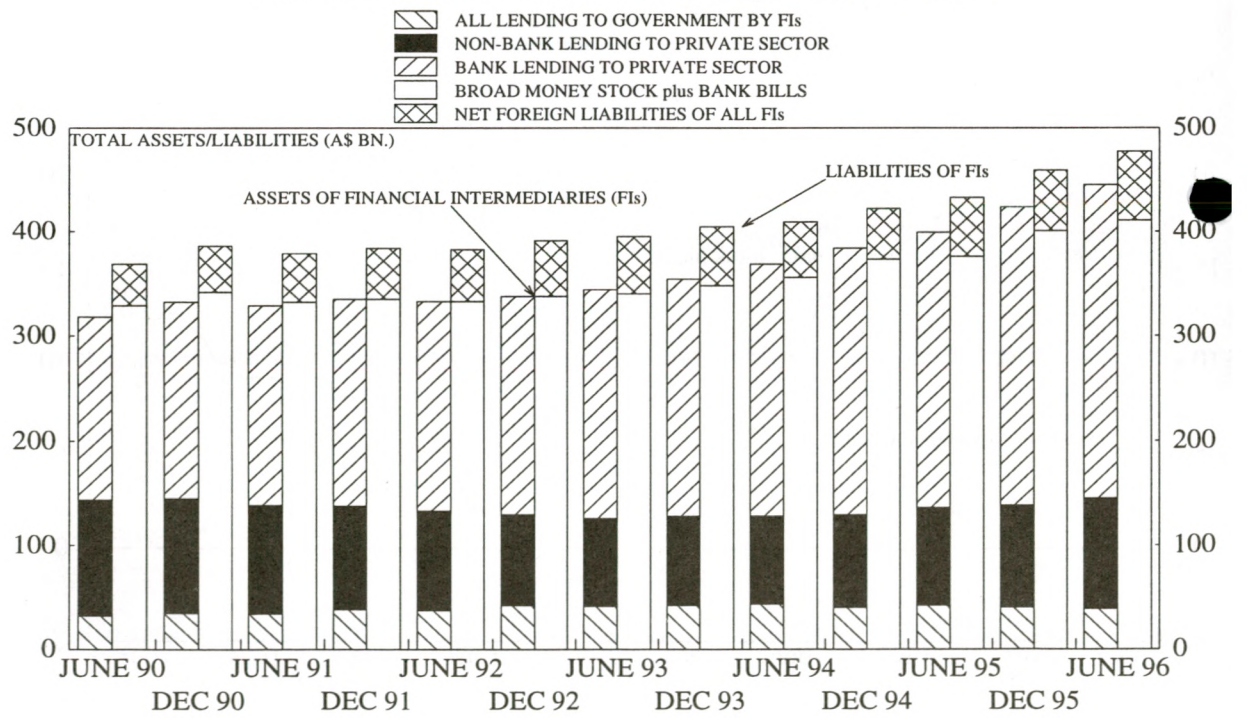
AUSTRALIA: CHART 6
ADJUSTED BROAD MONEY plus BANK BILLS AND TOTAL CREDIT



AUSTRALIA: CHART 7
LOANS TO DEPOSITS RATIO



AUSTRALIA: CHART 8
COUNTERPARTS TO BROAD MONEY plus BANK BILLS



the late 1980s (chart 8). Bank lending to the private sector grew by 14% over the last year. As this makes up the bulk of all financial intermediaries assets, it accounts for most of the growth in broad money plus bank bills which itself, grew by around 10% over the last year. Part of the expansion in bank and non-bank financial assets is funded by foreign capital. The stock of net foreign liabilities is equivalent to about 14% of all financial intermediaries liabilities and has grown strongly (by 16%) over the past year. To some extent this reflects the flattening of the yield curve discussed earlier.

Overseas capital is not only an important source of funding for the financial institutions, but for the government as well. This can be observed in the holdings of government securities shown in chart 9. While local banks have held 28-30 % of the total outstanding government bonds issued, consistently over the last 2-3 years, the share owned by the non-bank financial sector has steadily increased to around 17% in 1996. This would reflect the initial growth in private sector savings plans. However, the most noticeable change is the expansion in the share of the bond issues outstanding held in nominee accounts (42%), most of which are likely to be in the hands of non-residents. This confirms the foreign participation in the bond market rallies through 1995/96. It also explains some of the A$/US$ strength over the last 12 months.

Green shoots of recovery in 1997

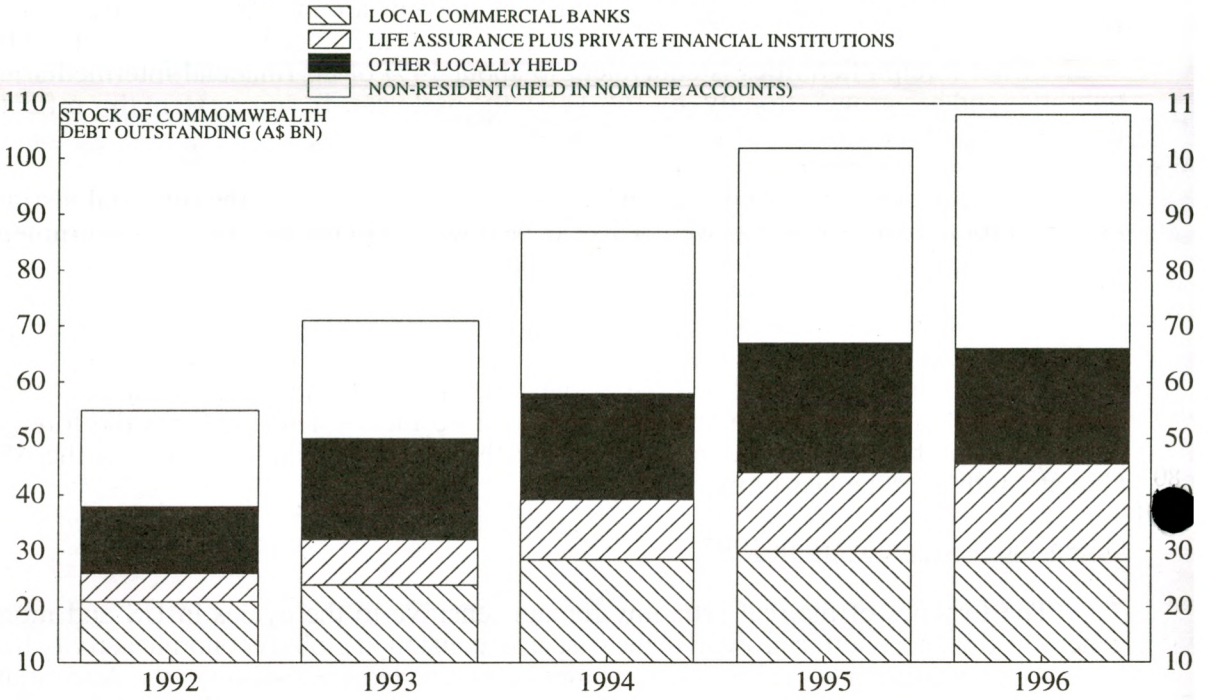
The fortunes of the real economy remain sensitive to the cycles in US and more generally global economic growth. In the past an expansion in global economic activity has led to a rise in commodity prices. This, in turn, has preceded an upswing in the Australian economy. Chart 10 shows how the OECD leading and industrial production indicators are useful guides to the timing of an upturn in Australian metals prices. Metal prices and the metals index compiled by the RBA in particular explain most of the variation in the A$/US$ rate (Chart 11). If economic conditions across the OECD continue to improve over the next 12 months then some strength in metals prices should follow. This in turn will give some support to the commodities sector and the A$/US$ rate (chart 11).

The domestic economy has showed mounting signs of a slowdown over the past year. There has been a slowing in industrial production over the past 12 months and a build up in inventories. New additions to capital stock have also been minor as shown by real private fixed capital expenditure in chart 12 . In general, businesses have found themselves faced with a profits squeeze. This arises from an environment where wage expectations have not yet fully adjusted to goods price disinflation. This year labour cost increases have been around 4% while weak pricing power in the goods market has made it difficult for manufacturers to retain the same profit margins as in previous years. Elements of consumption expenditure have also turned down in recent months. Retail sales and household disposable income growth have slowed although so far, the decline has been modest by historic standards.

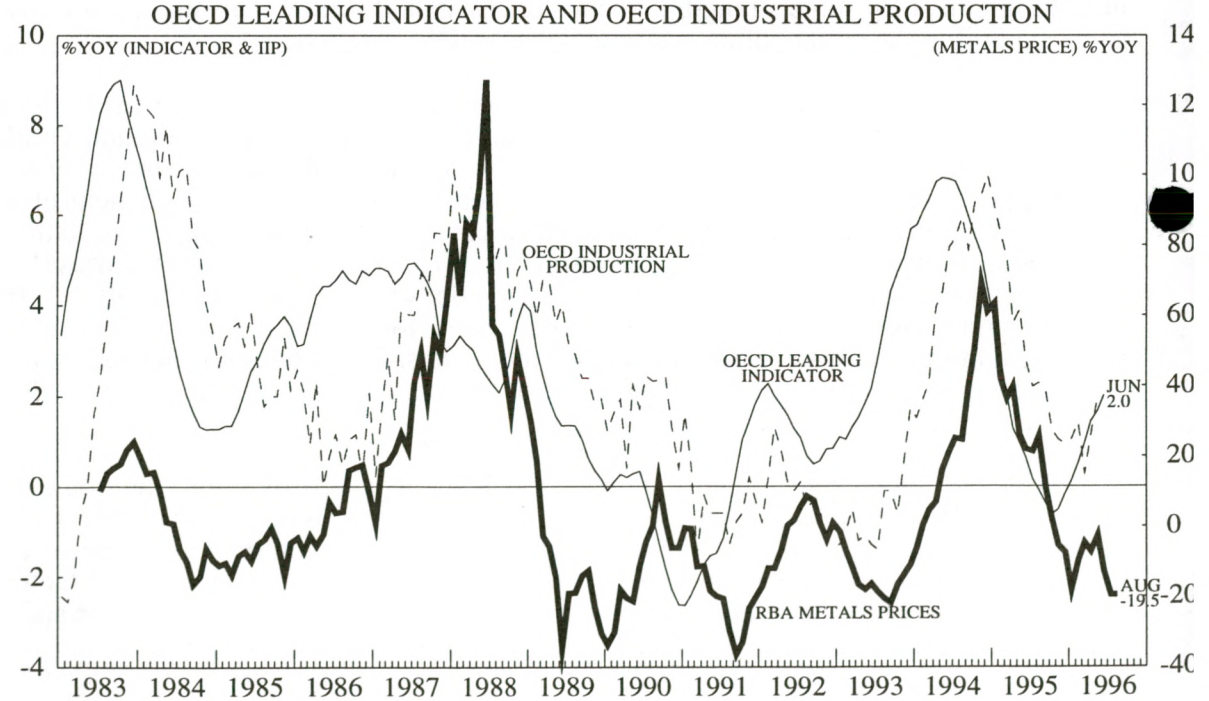
Much of the recent economic sluggishness is the lagged response to the monetary tightening in 1994. However, for the reasons described earlier, this economic cycle is likely to be more of a minor correction than a major protracted downturn. The shape of the forthcoming upswing in economic activity will likely be determined by external factors rather than by any monetary momentum present in Australia itself. This reflects the stable monetary conditions currently prevailing.

SUMMARY AND CONCLUSIONS: The real economy continues to experience a mid-cycle pause which is a lagged response to the monetary tightening in 1994. The shape and

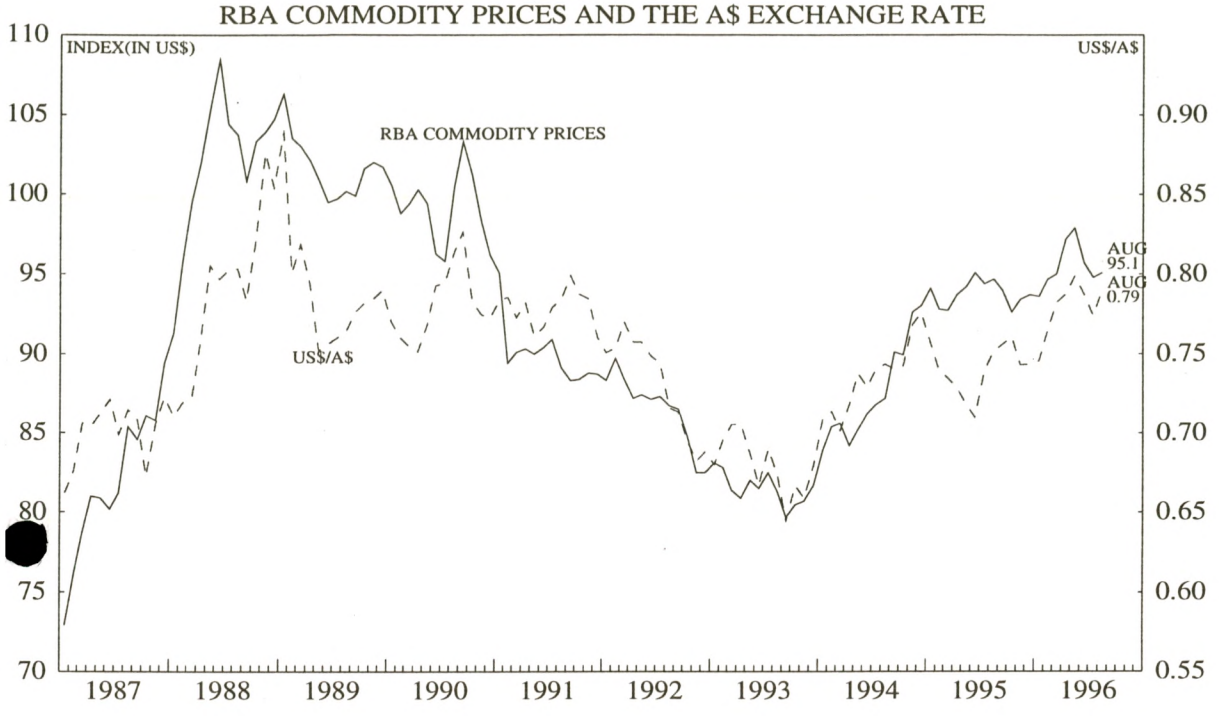
AUSTRALIA: CHART 9
COMMONWEALTH GOVERNMENT DEBT BY HOLDER



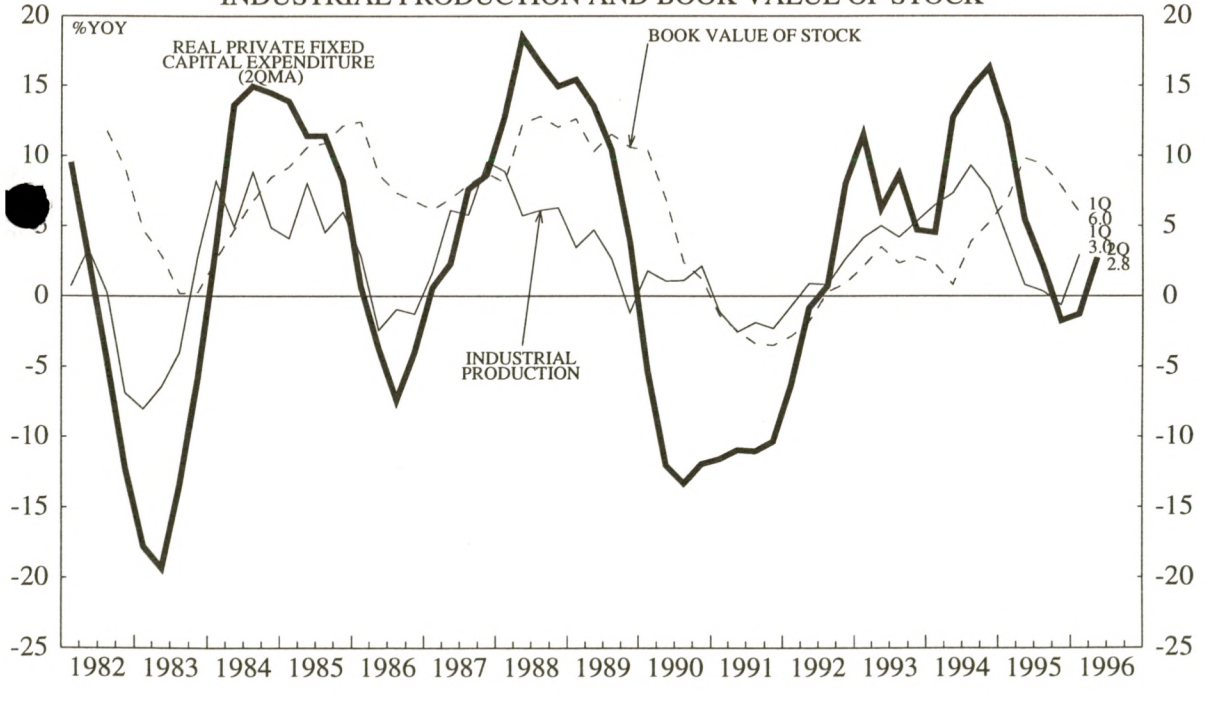
AUSTRALIA: CHART 10
GROWTH OF RBA METALS PRICE,
OECD LEADING INDICATOR AND OECD INDUSTRIAL PRODUCTION



AUSTRALIA: CHART 11
RBA COMMODITY PRICES AND THE A$ EXCHANGE RATE



AUSTRALIA: CHART 12
REAL PRIVATE FIXED CAPITAL EXPENDITURE
INDUSTRIAL PRODUCTION AND BOOK VALUE OF STOCK



stability of the yield curve along with the steady upward path of broad monetary growth suggest that monetary policy is benign. The demand for credit at the interest rates prevailing over the past year has been firm and credit growth has not reversed direction. This will provide some support to economic activity and help place economic growth on a more stable growth path, thus preventing the current downturn from being as protracted as that in 1990-92. The recent interest rate cut by the RBA was not strictly necessary to ensure recovery, but it will speed up the process of rejuvenation of the domestic economy. However, further interest rate cuts could begin to erode the fragile anti-inflation credibility that the RBA has earned. Consequently, any additional interest rate cuts would probably have to be reversed at some stage in 1997 if the low and stable inflation environment is to be retained. In the absence of further rate moves by the RBA, economic recovery in 1997 is more likely to be governed by the level of external demand next year, rather than by the current monetary policy settings.

JAPAN
REVIEW OF SHORT-TERM AND LONG-TERM GROWTH PROSPECTS

Introduction

Japan's recent stronger real GDP numbers have raised hopes that Japan's economy may resume the rapid pace of growth of previous decades (see chart 1). It therefore seems appropriate at this juncture to review our analysis of the different factors determining Japan's growth prospects, both from a long-term and short-term perspective, and both in nominal and real terms[1]: see "Japan: Short-term and Long-term Growth Prospects", AMM July-August 1993].

Short- and Medium-term Nominal Growth Prospects

Short-term nominal economic growth is largely determined by monetary factors. The quantity theory of money states that MV=PY, where M is the stock of money, V is the income velocity of circulation, and PY is nominal GDP. If velocity is stable, this means that changes in money supply should translate directly into changes in nominal GDP. However, with changing financial structures, velocity is rarely stable. Financial deepening has over recent decades reduced Japan's income velocity of circulation (in terms if M2+CDs divided by nominal GDP) by an annualised rate of 2% (see chart 2). Nonetheless, because the change in velocity has historically moved along a steadily declining trend, there has been a strong correlation between the year-on-year growth rate of M2+CDs and of nominal GDP one and two years later. Using these strong correlations, our model based on M2+CDs (see chart 3) has in the past provided a good guide to the approximate pace of nominal GDP growth over the next year. The most recent three quarters of nominal GDP estimates have, however, showed stronger growth than suggested by the model, raising the questions of why the relationship appears to have broken down and whether money supply growth will be a useful guide to growth in the future.

Part of the problem probably lies in errors of measurement of both money supply and nominal GDP (especially the preliminary estimates). M2+CDs does not include all assets which fulfill the functions of money, such as deposits with non-bank financial institutions (including Post Office Savings) and trust deposits. Although M3+CDs is broader (and includes PO Savings), it is published almost 3 months after M2+CDs, and has marginally lower correlation with nominal GDP growth. Nominal GDP estimates are also subject to errors of measurement, as evidenced by sometimes sizable revisions and controversies over technical details such as seasonal adjustments (especially how to deal with the leap-year day in Q1 of 1996) and imputed charges (e.g. the rising proportion of imputed rent in consumption, as a result of rising home ownership, but against the trend of falling actual rents). Moreover, the year-on-year growth rates of GDP in the first half of 1996 were boosted by the base effect (not fully accounted for by the model in chart 3) of a weak first half of 1995, when sentiment and activity was disrupted by the Kobe earthquake and the Tokyo subway gassing. Of course, the year-on-year growth numbers in the first half of 1997 will suffer from comparison with recent strong numbers.

A more fundamental problem is that the quantity equation MV=PY is really shorthand for MV=PT, where PT is the nominal value of all transactions in the economy, and

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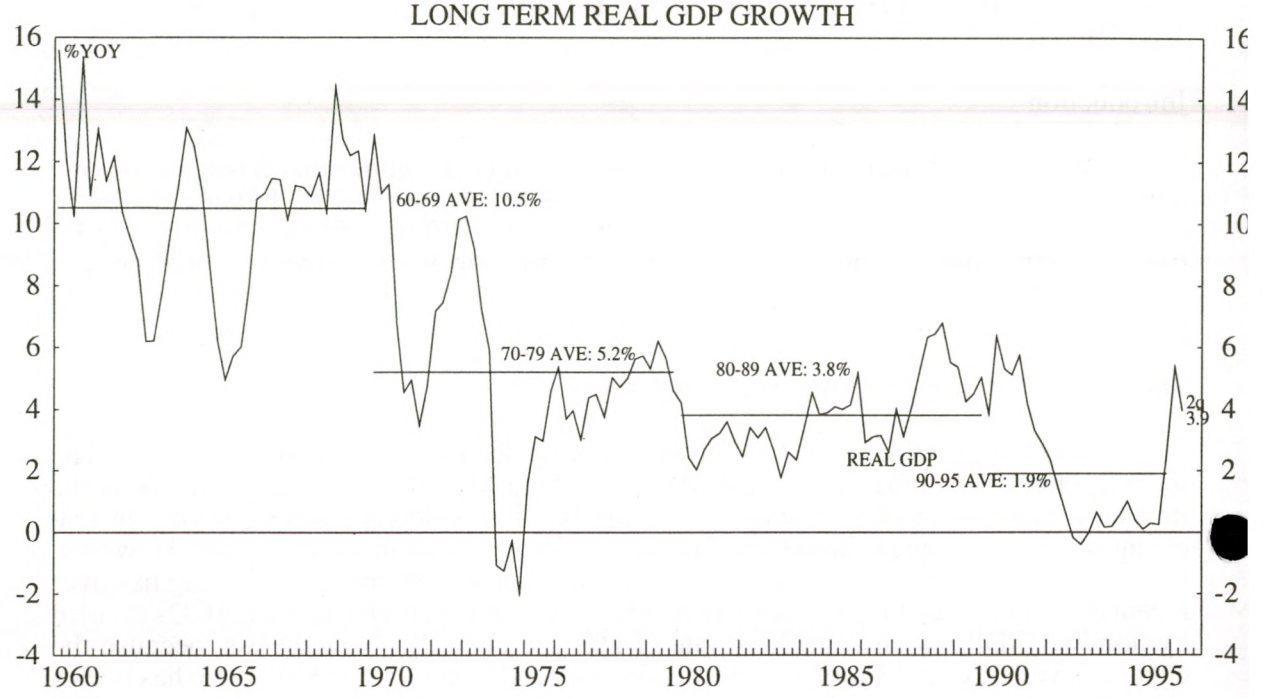
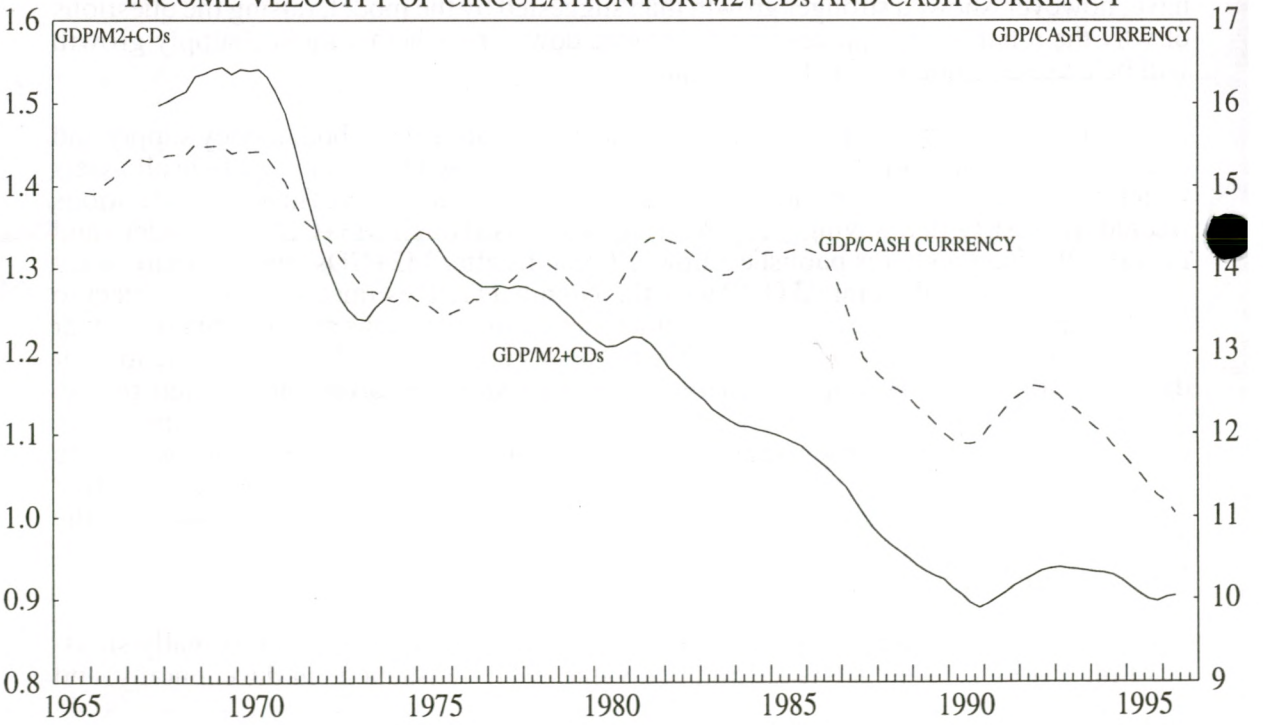
[1] See "Japan: Short-term and Long-term Growth Prospects", AMM July-August 1993

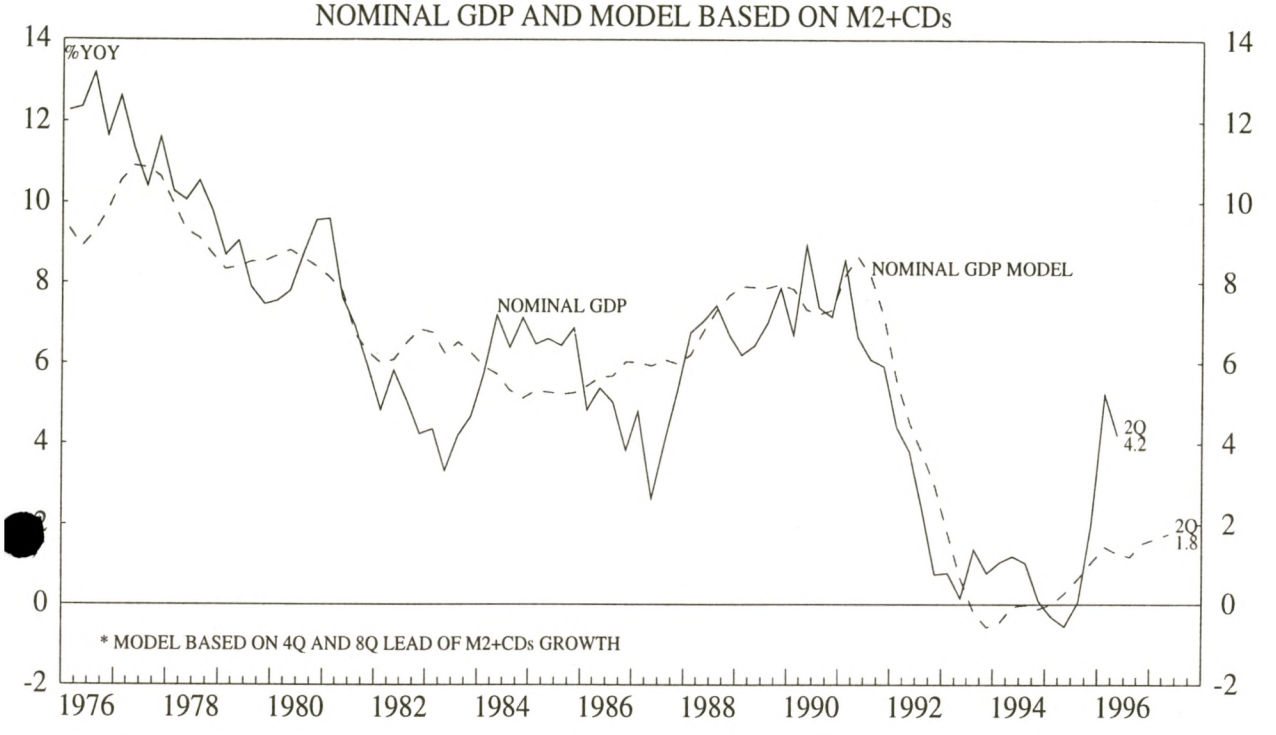
JAPAN: CHART 1
LONG TERM REAL GDP GROWTH



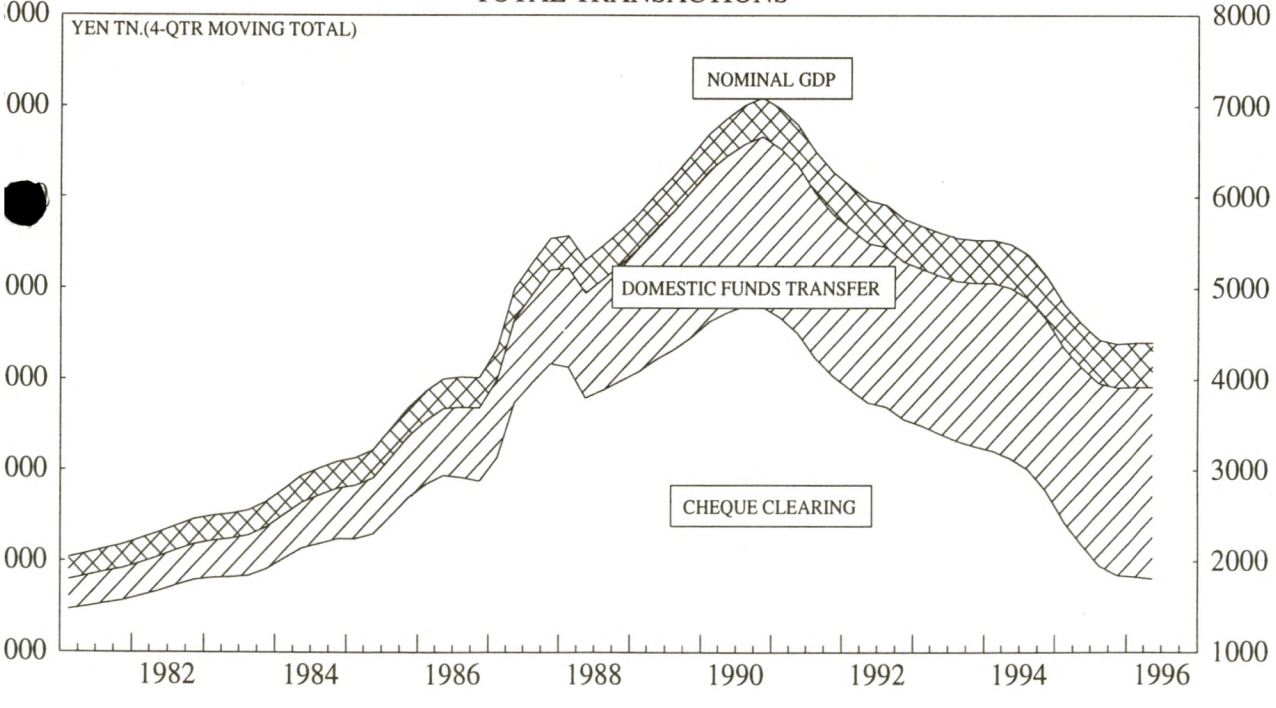
JAPAN: CHART 2
INCOME VELOCITY OF CIRCULATION FOR M2+CDs AND CASH CURRENCY



JAPAN: CHART 3
NOMINAL GDP AND MODEL BASED ON M2+CDs



JAPAN: CHART 4
TOTAL TRANSACTIONS



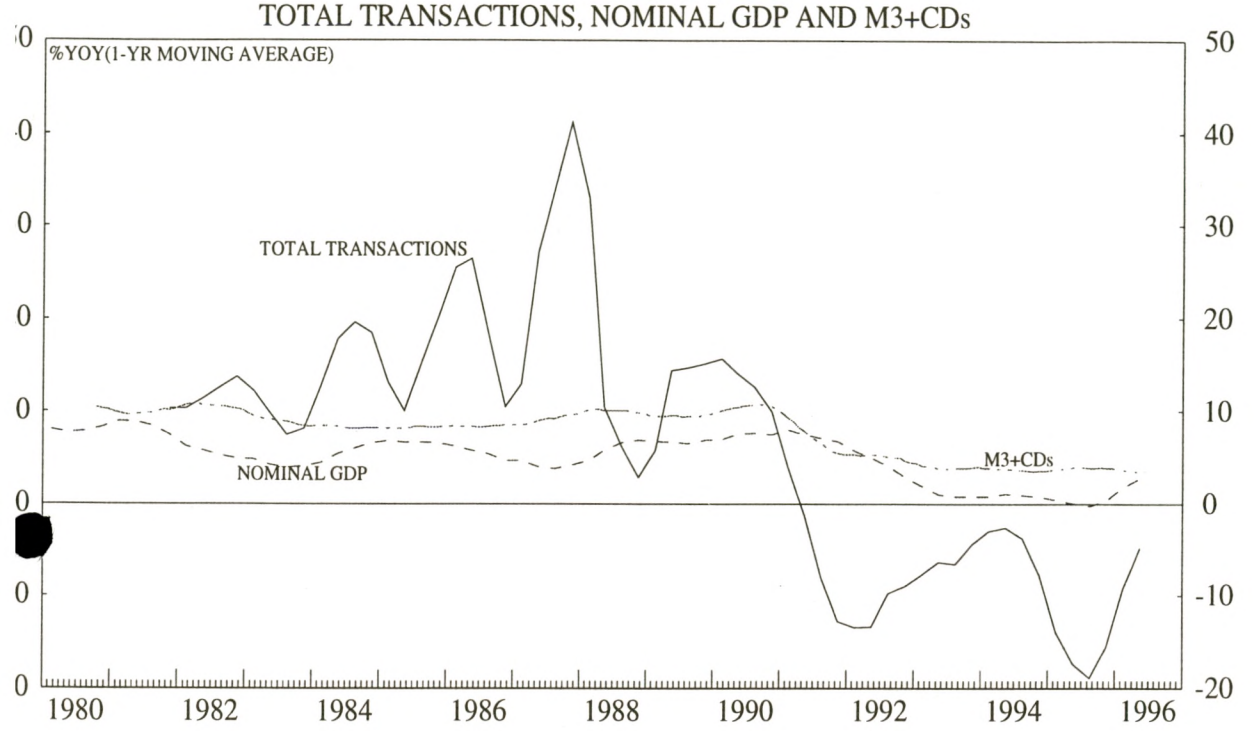
where PY/PT (the ratio of final demand to total transactions) is assumed to be constant. However, PY is not equal to PT. PY (nominal GDP) measures final demand in the economy, whether transacted or not. Some elements of final demand, such as imputed rents for owner-occupied housing, are not transacted. PT (total transactions value), however, includes not just transactions of final demand, but transactions of intermediate goods and (second-hand) transactions of existing physical and financial assets. Because of the difficulty in measuring PT (in particular the value of cash transactions) economists have tended to focus on PY and assumed that the level of transactions consistent with a given level of final demand (PY/PT) remains constant over time, or follows a consistent trend. To test whether this assumption has been valid in Japan, we have estimated a proxy for the total value of transactions in the economy using official data on cheque clearing and domestic funds transfer (which together amount to about 9 times the value of nominal GDP). On the simplifying assumption that all of final demand is transacted on average once with cash, we have added in an estimate of cash transactions equivalent to nominal GDP. These components and the resulting estimate of overall PT is shown in chart 4 (in level terms) and along with PY and M (M3+CDs) in chart 5 (in %yoy growth rates). The most noticeable feature is that PT grew far more rapidly than PY and M during the bubble of the late 1980s, and has contracted far more severely during the downturn of the early 1990s. In other words, PY/PT fell rapidly during the bubble, and rose rapidly during the post-bubble down-turn -- hardly constant or in line with a consistent trend!

This rise in transactions relative to GDP during the second half of the 1980s and the subsequent reversal in the first half of the 1990s was in large part due to activities in markets for financial assets and real estate. However, structural changes in the real economy as a result of the economic downturn are probably also serving to reduce the number of transactions needed for a given level of output. This would partly be because major manufacturers have traditionally used subcontractors as marginal suppliers and brought subcontracting work in-house (and out of the total transactions) during economic downturns, rather than lay off their own workforce. Another more positive reason is the structural change in Japan's notoriously complex wholesaling and retailing sectors, where distribution chains are being shortened, thereby reducing the number of intermediate transactions for each final demand transaction.

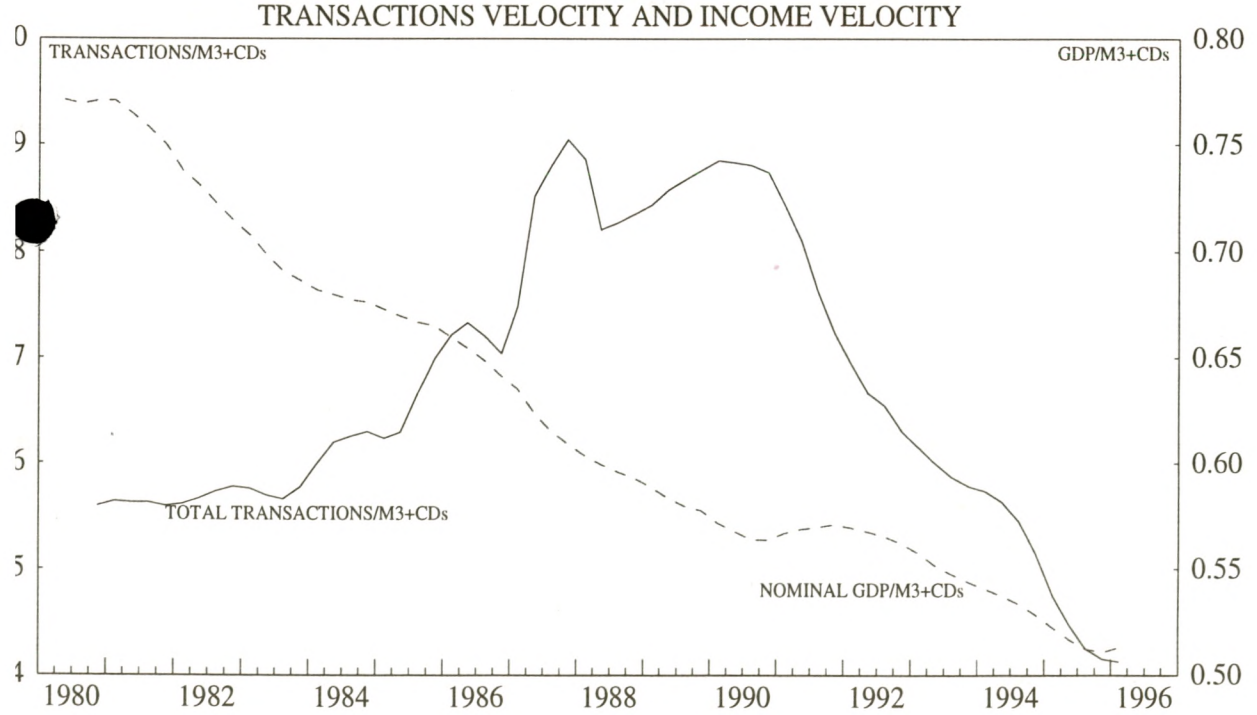
PT finally appears to have stabilised and even registered modestly positive year-on-year growth in the first half of 1996. To gauge whether this may be a real turning point, let us examine the relationship between PT, PY and M in terms of V, i.e. velocity of circulation (see chart 6). As mentioned earlier, income velocity has been on a long-term downward trend. Transactions velocity, however, was relatively stable around 6 times in the early 1980s, ratcheted up to 9 times during the bubble, and has since declined to 5 times. Given the modest but steady growth in M3+CDs and the recent trough in the transactions velocity of circulation, further falls in PT, the total value of transactions in the economy, are probably limited. Velocity therefore looks set to be more stable, and both PY and PT can be expected to move more in line with M in the medium term future.

Growth of broad money, whether measured by M2+CDs or M3+CDs, has so far been quite modest (see chart 7), in spite of record low nominal interest rates. This sluggish money supply growth is, however, not surprising given the ongoing balancesheet adjustments in the banking sector and corporate sector. Looking at the counterparts to growth in M2+CDs (see chart 8), it is evident that the expansionary fiscal policy has not been monetised but has in fact been a negative drag on money supply, while the contribution from foreign exchange intervention has faded in the first half of 1996. Meanwhile, private sector credit has accelerated somewhat, and money continues to be created from 'other' counterparts -

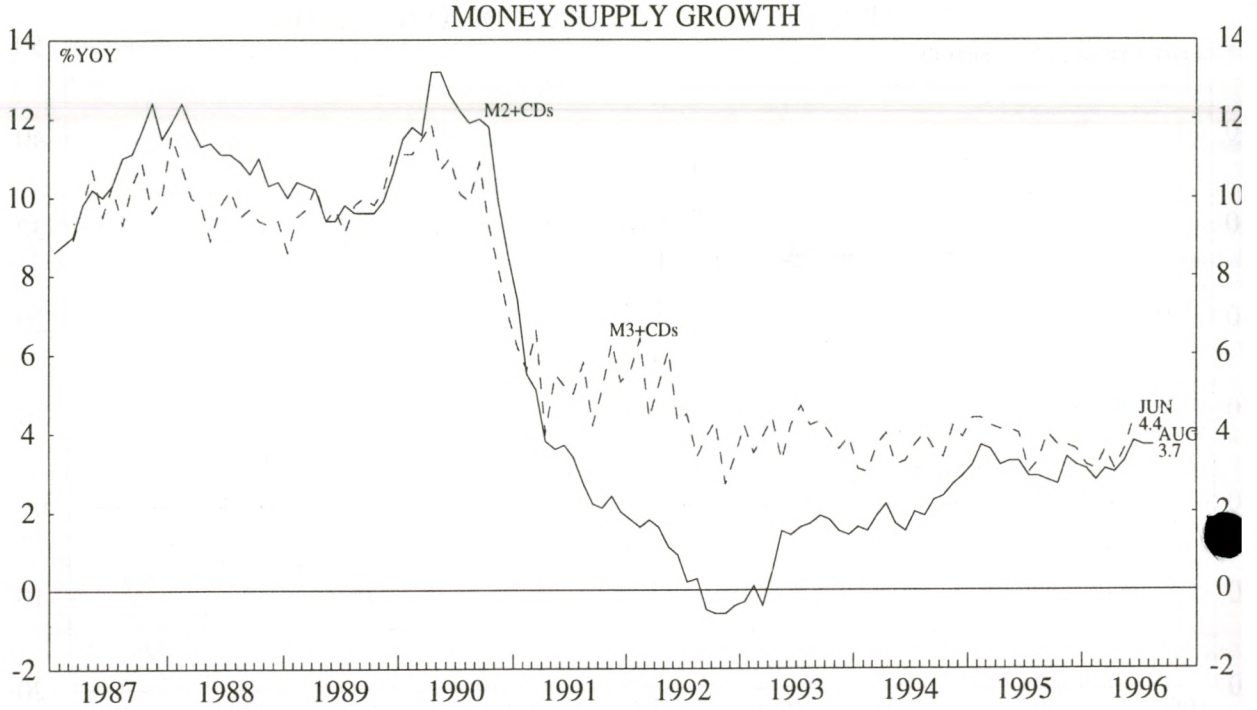
JAPAN: CHART 5
TOTAL TRANSACTIONS, NOMINAL GDP AND M3+CDs



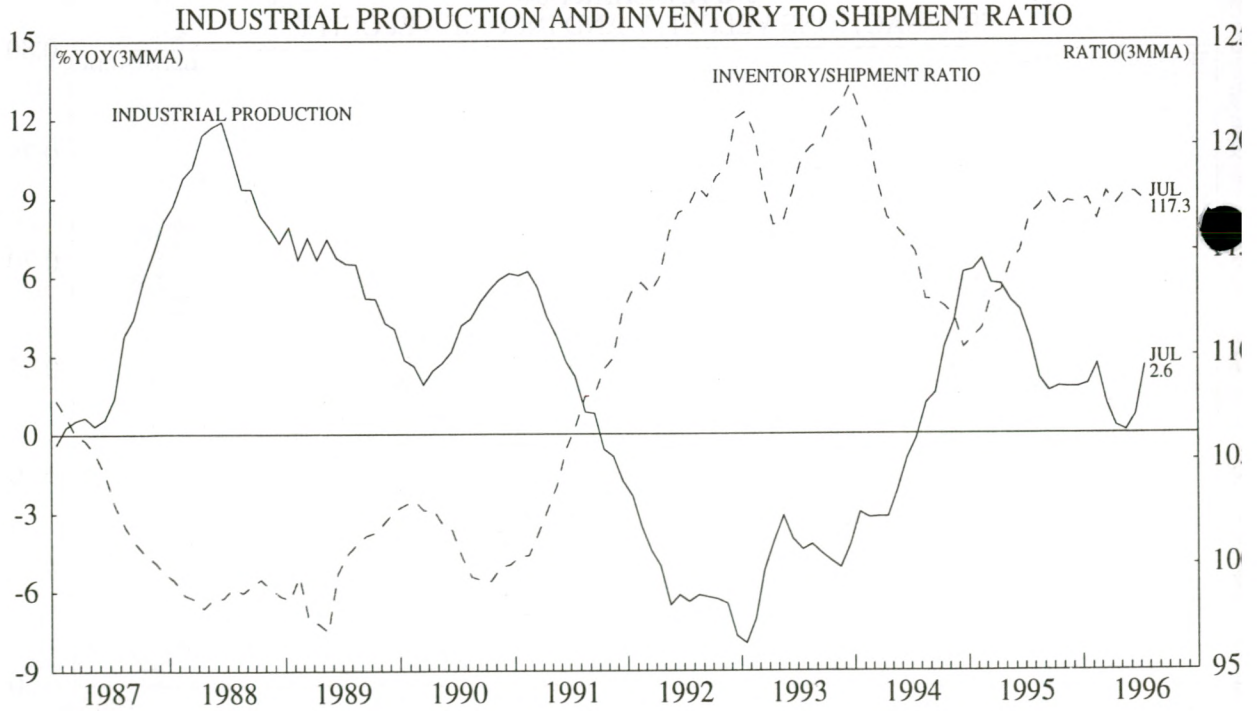
JAPAN: CHART 6
TRANSACTIONS VELOCITY AND INCOME VELOCITY



JAPAN: CHART 7
MONEY SUPPLY GROWTH



JAPAN: CHART 8
INDUSTRIAL PRODUCTION AND INVENTORY TO SHIPMENT RATIO



mainly maturing trust deposits or 'broad' and 'wide' deposits (long-term time deposits not included in M2+CDs). However, corporate credit demand remains weak, and the main area of expansion appears to be consumer credit. Unless the authorities are prepared to increase their direct injections of money through unsterilised foreign exchange intervention or increased monetisation of public spending, further money supply growth has to be provided by the banking sector. The banking system is, however, constrained by an overhang of non-performing loans, and by a lack of credit demand from (the credit-worthy parts of) the corporate sector. The full extent of the bad loan problems in Japan is difficult to gauge given the lack of genuine arms-length transactions in real-estate, the main underlying asset for bad loans. However, while a few of the more prudent institutions may be close to having resolved their problems, other problems are emerging, and it is difficult to declare the book closed until the bad loans have been fully liquidated and the value of the underlying collateral realised. In the light of these constraints, growth of broad money supply looks set to remain modest in the near-term future, capping the outlook for overall nominal GDP growth.

Short-term Real Growth Prospects

Short-term real growth prospects depend partly on the nominal monetary factors outlined above, but also on real expenditure propensities of the various sectors in the economy. Monthly data in 1996 on both production and consumption has been very volatile, as the leap-year calendar effect has significantly affected the number of week-days and week-ends in each month. Hence the following sector charts all use 3 month moving averages to smooth out otherwise volatile data.

A number of factors cloud the outlook for industrial production. Firstly, production appears vulnerable to further adjustment in the still high level of manufacturers inventories of finished goods relative to final sales (see chart 8). Secondly, the upswing in recent years in industrial production has been heavily concentrated in production of electrical equipment, an area of increasing concern given the fall in the market price of semiconductors. Thirdly, the upswing has been driven by capital goods more than by consumption goods. The deployment of these capital goods (both in Japan and abroad) will have created capacity and boosted potential output. Indeed, estimates of both capacity utilization and the overall (GDP based) output gap suggests that output can expand significantly without hitting capacity constraints. However, the existence of excess supply capacity and increased international competition will limit the pricing power of Japanese producers. Hence, if final demand, by way of a consumption cycle or an export boom, fails to turn upwards vigorously, there is a danger that Japan Inc. may have over-invested and that the recent (private and public) investment-led upswing may come to an early end.

Fortunately, the outlook for private consumption looks reasonably positive. Total compensation of labour has been rising in both real and nominal terms. The household survey shows modest growth in incomes. Personal sector deposit balances are growing faster than overall money supply. Recent strong housing starts hint at stronger housing-related consumption (consumer durables, furniture, wallpaper, etc.) over the next year or so. The planned increase in consumption tax from 3% to 5% in April 1997 may well serve to front-load a modest amount of purchases of consumer durables in the first quarter of next year, just as it has probably boosted housing starts in recent months (starts registered before end-September 1996 get taxed at old rate of 3% rather than new rate of 5% irrespective of completion date). Vehicle sales may be boosted slightly in coming months following the recent introduction of new models by the major manufacturers. However, given the continued uncertain conditions in the labour market, the pace of overall con-

sumption growth is likely to remain moderate. Coincident indicators, such as the household survey and retail sales data (see chart 9) confirm the moderate pace of the recovery in consumption so far.

Throughout the economic downturn, the government has attempted to implement ever-increasing fiscal stimulus packages. However, because of the deteriorating state of central and local government finances, and due to procrastination and obfuscation in the implementation of public spending, the contribution of public demand to overall real GDP growth had been negligible (or even negative) until the three most recent quarters of data (see chart 10) - public spending data which could still be subjected to substantial revisions in the light of further data on local government spending. Looking ahead, the supplementary budget for the current fiscal year looks set to be delayed until after the election, and looks set to be of a much smaller size than previous fiscal stimulus packages. Moreover, the poor state of public finances make it likely that the planned increase in consumption tax in April 1997 will go ahead, and that exceptional income tax exemptions of previous years will not be continued in 1997. All in all a contraction in fiscal policy looks inevitable. This should of course free up resources for the private sector, but unless the financial sector makes those resources available and unless households and businesses feel sufficiently confident to go out and deploy those resources, the contraction of fiscal policy could have a negative impact on real economic activity.

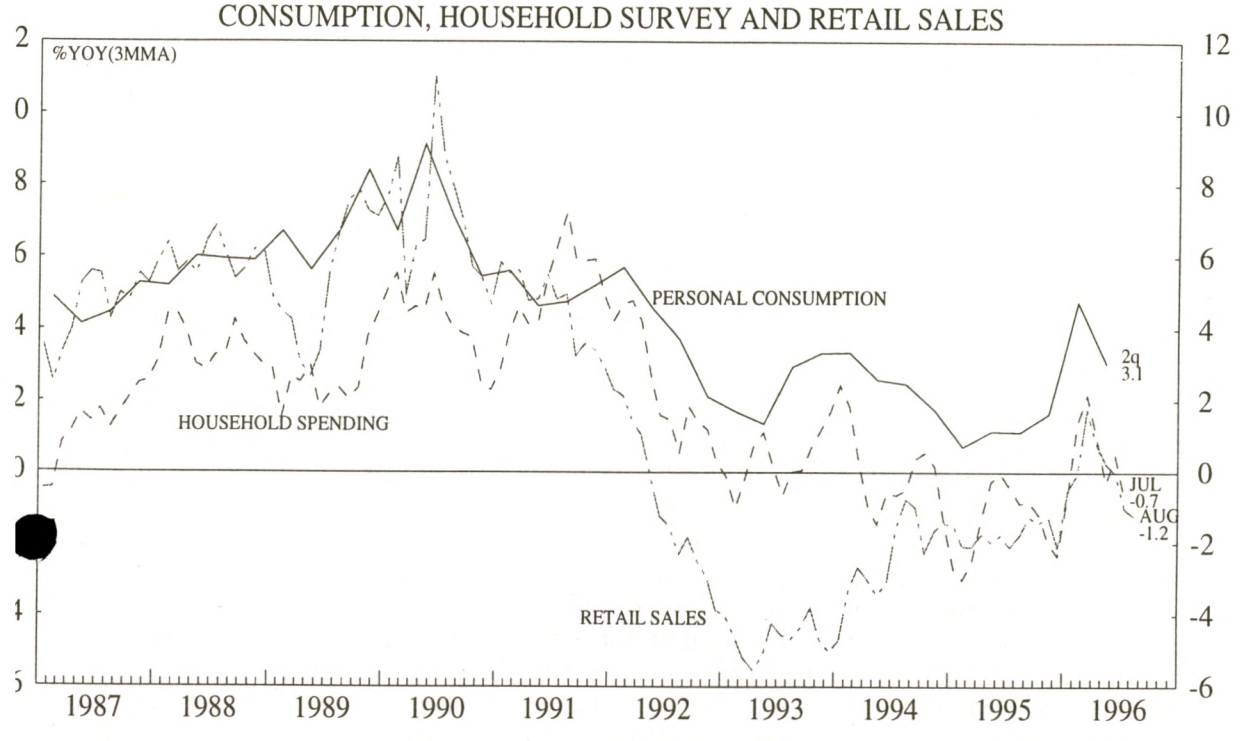
Net exports have been a negative drag on GDP growth since 1993, as the trade surplus has contracted. Import growth is still exceeding export growth in volume terms, as deregulation, market opening, and increased production by Japanese companies abroad increases import penetration and erodes Japan's export base. The weakening of the yen/dollar exchange rate from 80 to 110 has only erased a small amount of the preceding decades of excessive yen strength, and in any case import and export volumes have proved themselves highly price inelastic in the short run. In other words, a weaker yen means a higher import bill more than it means higher export revenues. The trade surplus can therefore be expected to continue to fall (although at a more moderate pace) and the contribution from net exports to annual real GDP growth looks set to remain negative (although it too will moderate to around -1% of GDP).

Overall then, we expect the year-on-year growth rate of real GDP to moderate to around 2% in the second half of 1996, and to dip into negative territory in the first quarter of 1997 due to the negative base effect of the strong first quarter of 1996.

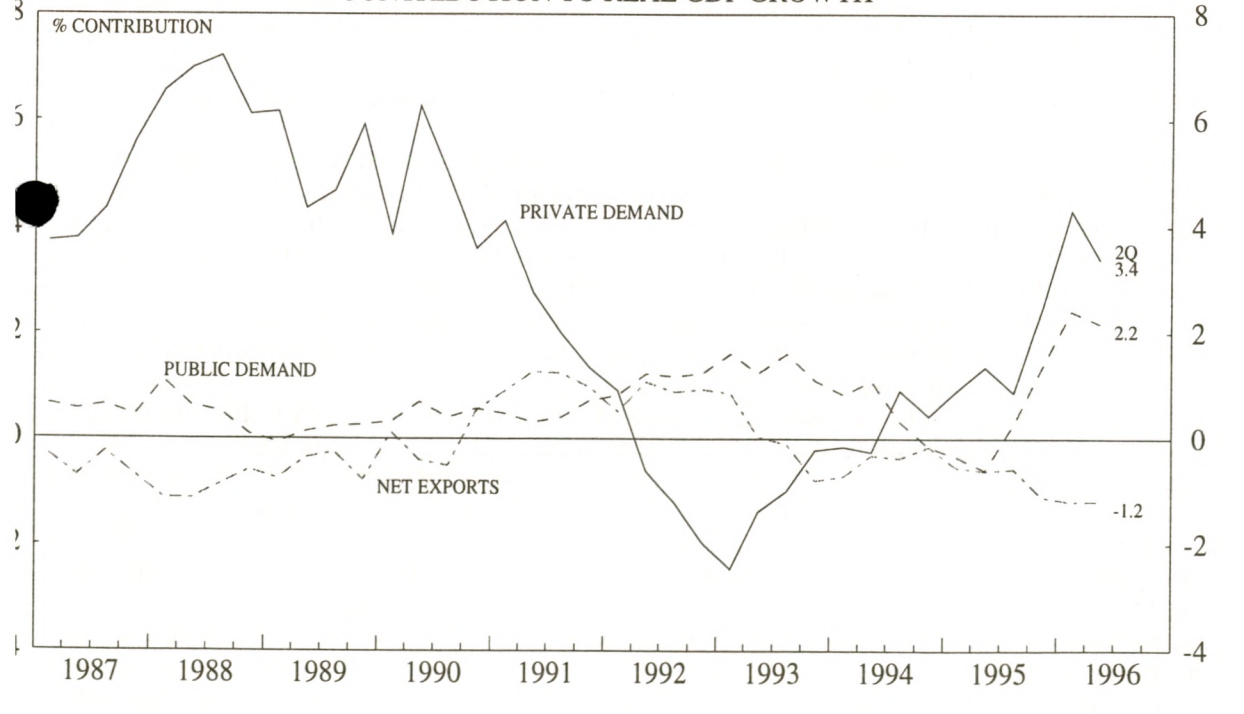
Long-term Real Growth Prospects

Looking further ahead, long-term prospects for real economic growth depend on growth in factor inputs and on growth in factor productivity. In its simplest mathematical notation, Y=(Y/L) L, where Y is real income, L is labour input and Y/L is labour productivity as represented by the output/labour ratio. Examining the growth rates of Y/L and L (see chart 11), it is clear that the bulk of Japan's growth has come from a rising Y/L, rather than from increases in labour input. However, it is also clear that rises in Y/L have slowed down significantly in the 1990s compared with previous decades. Looking ahead, Japan's labour force looks set to shrink 66.6 million workers in 1995 to 57.5 million in 2025 - assuming a constant participation ratio of 76.5% of the working age population applied to Ministry of Welfare population projections (which admittedly assume a rising birth rate while the actual birth rate has continued to decline). The implication of this future decline in the Labour Force (but not noticeably so in the overall population, which merely ages) is that labour productivity will have to grow at 0.5% per annum just to keep real output

JAPAN: CHART 9
CONSUMPTION, HOUSEHOLD SURVEY AND RETAIL SALES



JAPAN: CHART 10
CONTRIBUTION TO REAL GDP GROWTH

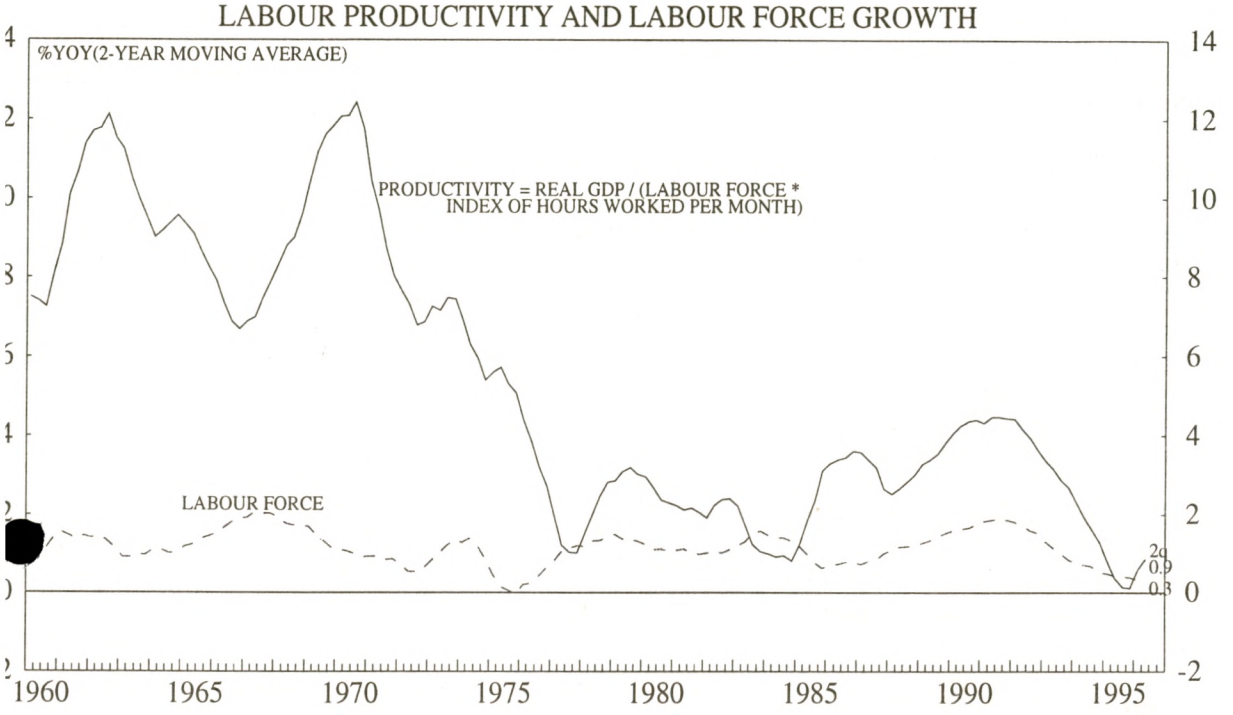


constant. Obviously much higher labour productivity growth would be needed to produce stronger real GDP growth.

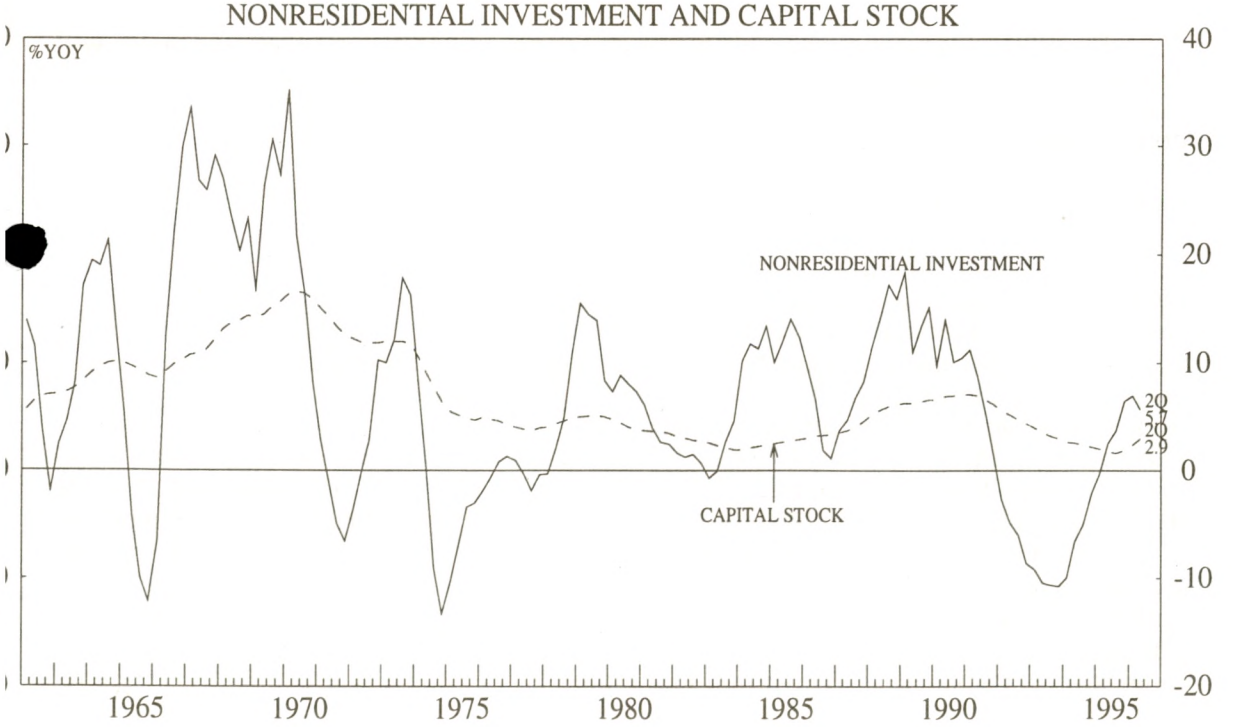
Labour productivity is a function of several factors: changes in inputs of other factors of production (mainly capital and land), technological innovation to increase total factor productivity, allocation of factors of production (both labour and capital) to more productive sectors, and arguably the intrinsic efficiency of workers themselves (in turn a function of skills, experience, adaptability, physical health, incentives, motivation, etc.). Of other factor inputs, the supply of land can be assumed to be constant (although its allocation may change over time, and some additional land reclamation is possible at the margin), and we can focus on the input of capital. Although residential housing does provide a stream of output by way of rented or owner-occupied accommodation (which are counted in GDP), it does not feed directly into the production process and may be regarded as tangential to our discussion of productivity. We therefore focus on non-residential capital stock, calculated on the basis of national accounts data on non-residential Real Gross Domestic Fixed Capital Formation and assuming a 10 year real depreciation period for new capital (see chart 12). This estimate of changes capital stock has tended to follow changes in productivity pretty well, with one noticeable exception -- accelerating investment in the 1980s did not lead to accelerating growth in labour productivity. This exception merely illustrates the wastefulness of investment during the bubble economy, fueled by readily available capital, negative real interest rates and seemingly ever-rising asset prices. Although nominal interest rates are now at record lows, deflation of domestic prices means that real interest rates are still positive, while aggregate labour costs are still rising. Moreover, the absolute level of the cost of doing business in Japan (due to the high cost of land, labour, utilities and regulation) is still significantly higher than in other countries, as evidenced by cross-country cost surveys by management consultants and by the revealed preference shown in the increasing outward direct investment by Japanese companies. This means that domestic capital investment, which has been boosted recently by long-overdue retooling in the auto-industry and by growth in telecommunications and semiconductor industries, is unlikely to grow at the rapid pace of the 1980s bubble years or the pre-1973 period of rapid industrialisation, unless and until there is a significant improvement in business conditions, either through rising nominal demand or through declines in the cost of doing business.

However, increasing investment is not the only way to increase labour productivity in Japan. Rigidities in all the markets for all factors of production (land, labour and capital) means that the allocation of factors of production is still very inefficient. Rigidities in the land market includes an unwillingness by financial institutions to sell the land underlying the bad debt collateral, capital gains tax, lack of transparency in data on transactions, rigid zoning regulations and high transaction costs. Rigidities in the labour market include the vestiges of the lifetime employment system, seniority-based pay, non-portability of pension schemes, government subsidies for companies to keep redundant workers employed, lack of geographical mobility caused by high costs of housing, and regulatory requirements for excess workers (e.g. minimum of 4 qualified attendants at petrol station forecourts, effectively banning self-service petrol stations, and requirements for human traffic controllers at all sides of roadworks). Rigidities in the capital market include lack of transparency in corporate accounts, lack of adequate and transparent pricing of credit risk, left-overs of compensating balance deposits by borrowing companies (an untransparent way of pricing credit risk), excessive reliance on land as collateral for lending, an equity market still dominated by cross-shareholdings valued for business relationships rather than for return on investment and buoyed up by public sector support for the market. The cost of compliance with excessive regulation, and the aforementioned factor market inefficiencies, feed through into the whole cost-structure of the economy, into the cost of transport, utilities, business

JAPAN: CHART 11
LABOUR PRODUCTIVITY AND LABOUR FORCE GROWTH



JAPAN: CHART 12
NONRESIDENTIAL INVESTMENT AND CAPITAL STOCK



services, and virtually everything else in the economy. Of course, the existence of excessive deregulation, allocative inefficiencies and high overall costs leaves plenty of scope for regulation, efficiency gains and cost reduction. However, the pace of such positive structural change has so far been painfully slow, and large potential gains in productivity still look some way off.

Long-term Nominal Growth Prospects

Japan urgently needs to achieve structural change in order to increase productivity and maintain, or preferably improve, its level of economic welfare. However, obstacles are in the way in terms of distorted relative prices and balance sheet pressures. The relative price distortions similarly pervade prices throughout the economy: high cost of housing relative to incomes, high price (i.e. low yield) of financial assets relative to assets elsewhere, high relative price of food, relative wages which don't reflect the marginal productivity of labour, and above all else an overvalued real exchange rate in terms of almost any measure of the costs of doing business, consumer prices, wages, unit labour cost, etc. Balance sheet pressures resulting from the post-bubble rise in interest rates and fall in asset prices are evident in the both the financial sector (where bad loans are a bad asset), in the corporate sector (where resources are tied up in technically, but not yet legally, bankrupt companies), and in the personal sector (where the incidence of negative equity and personal bankruptcy is still understated). The various balance sheets of the public sector is now beginning to suffer from having to support the economy (through fiscal stimulus packages and cheap loans from public financial institutions) and the financial system (through overt financial bail-out packages as well as through the implicit subsidy for the financial system through the steep yields curve). In addition to these existing balancesheet problems, there is the incipient balancesheet problem of unfunded future pension liabilities, which look set to rise significantly with the aging of the population.

Resolution of balance sheet problems and correction of distorted relative prices will require significant transfers of resources within and between sectors and significant changes in absolute prices. The transfer of resources for clean-up of indebted balance sheets can be done transparently through taxes and subsidies, used for bailouts and liquidations, with resulting deflationary pressure on land prices, wages, and to a greater or lesser extent on most other prices in the economy.

Alternatively, the transfer of resources and correction of relative prices can be effected in an opaque way through inflation, allowing most prices to rise but some prices to rise faster than others. In the near term, inflation of domestic prices is being prevented by an overvalued exchange rate and by the modest growth rate of broad money supply. However, in a longer term, given the deterioration of public finances and with increasing realisation of the scale of the structural imbalances, monetisation of the public and private sector debt problems in the economy looks set to become an increasingly tempting option. However, the magnitude of inflation required to correct relative price imbalances and alleviate balance sheet problems is probably in the region of a doubling or tripling of certain prices, a scenario which would require a massive acceleration of money supply growth, a much weaker nominal exchange rate. High inflation is politically more acceptable when a greater part of the population have their living standards protected through indexation or rising nominal incomes. Given the aging population structure in Japan, and the absence of formal indexation of pensions, a hyper-inflationary solution does not appear politically attractive.

The most likely scenario for the next 2-3 years is continued modest nominal growth in line with money supply growth, with significant deflationary pressures on certain prices,

such as land prices (due to liquidation of bad loans) and food prices (due to further deregulation). The acceleration of M2+CDs growth from below 0% in 1992/93 to over 3% recently will probably limit the overall deflationary bias in the economy, while the exchange rate will probably continue to bear the brunt of the adjustment in relative prices. While credit growth remains subdued, domestic prices continue to fall and the exchange rate remains overvalued, the present policy of very low nominal interest rates will remain appropriate. However, an increase in interest rates will become appropriate at some point, probably in 2-3 years time depending on the pace of deregulation and structural adjustment. If at that point the authorities decide to continue the policy of low interest rates (perhaps rationalised by a perceived need to compensate for a consolidation of fiscal policy), the situation could become inflationary. However the point where inflationary pressures necessitate higher interest rates is still some way off.

SUMMARY AND CONCLUSIONS: In the short term nominal GDP growth is likely to be constrained to a trend growth rate of around 1.5% given the sluggish 3-4% growth in broad money supply (which in turn is constrained by banking sector balance sheet problems), while continued modest deflation will boost this to 2% in real terms. However, real growth appears vulnerable to incipient fiscal tightening, excessive inventories, and a possible slowdown in capital investment.

In the long term Japan will have to deregulate, restructure and reduce the cost of doing business in order to increase productivity and compensate for a falling workforce. So far progress in these areas has been disappointing, but pressures for change are mounting and structural change looks set to accelerate. For the time being the corrections of relative price imbalances look set to be effected through gradual exchange rate depreciation and modest deflation. Risks of inflation still appear some way off.

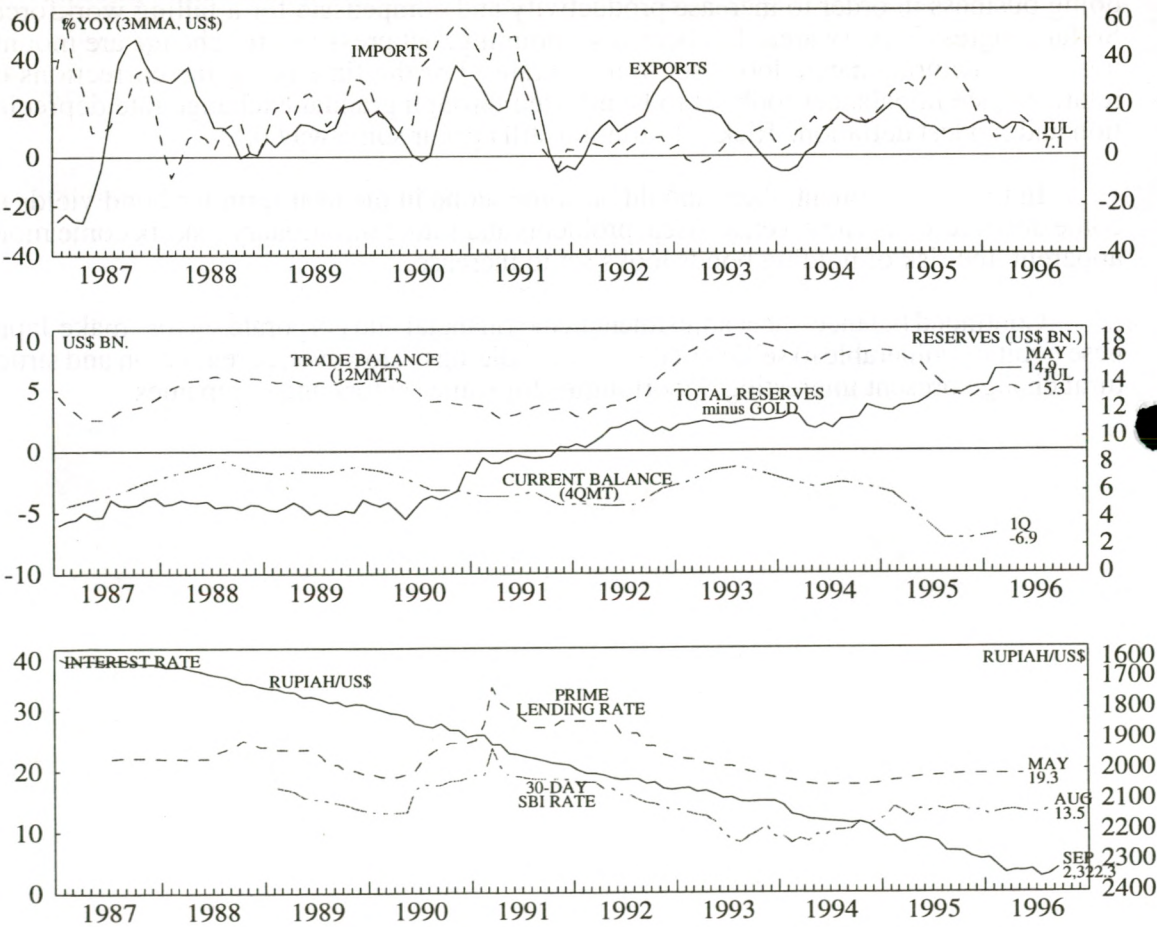
In this environment, there should be some scope in the near term for bond yields to come down further. However, as fiscal problems and future inflationary risks become more apparent, the risk of holding bonds looks set to increase.

Continued balance-sheet adjustment in the financial and corporate sectors make Japanese equities vulnerable to selling of cross shareholdings. However, deregulation and structural change present interesting opportunities for some sectors and companies.

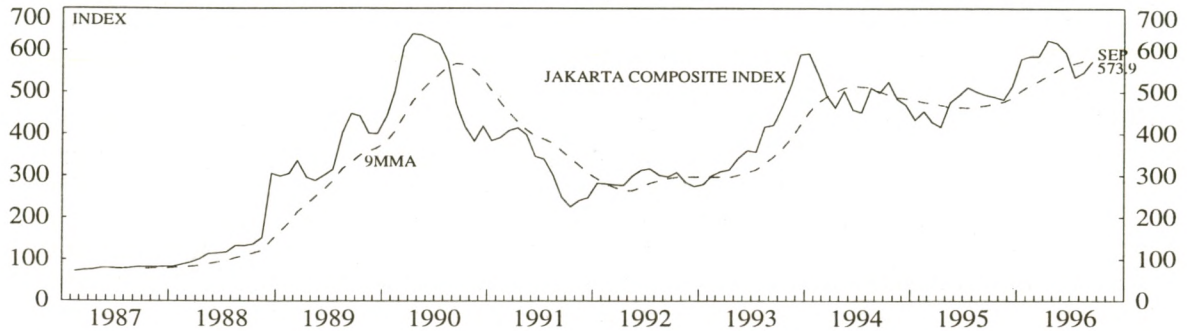
INDONESIA: FURTHER MOVES TO RESTRAIN EASY MONEY CONDITIONS

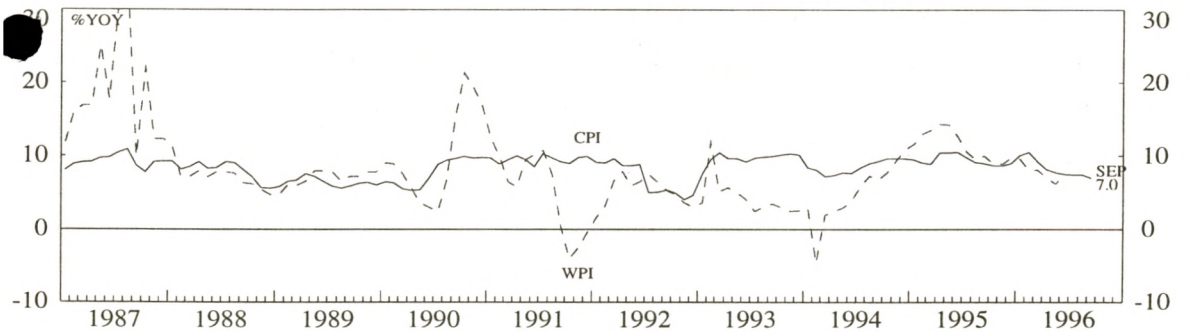
Through most of 1996 Indonesia has continued to experience strong inflows of foreign capital and steady accumulation of foreign exchange reserves. This coupled with the operation of the downward crawling Rupiah/US$ exchange rate has led to persistently stimulative monetary conditions. 1 month interest rates have declined and remained around 14.5% while broad monetary growth had accelerated to 30% in June. Over the past year the central bank has tried to reduce the inflow of foreign capital by widening the fluctuation range of the exchange rate within its bands three times, from +/- 2.5% to +/- 4.0%. Attempts to rein back on existing monetary conditions have taken the form of encouraging banks to be more prudent in their lending policies, and in August, announcing a rise in the statutory reserve requirement ratio from 3% to 5%, to take effect next April. Meanwhile, the rate of bank credit grows more steadily at rates of around 22%. While export growth in many of its neighbours has decelerated sharply, Indonesian export growth has remained relatively steady registering low double digit growth through the first half of 1996. Import growth has stabilised from the deceleration at the start of the year and so the trade surplus has stopped improving. In the absence of an improvement in export growth through the balance of this year, the trade surplus will be vulnerable to contraction if there is an expansion in import demand.

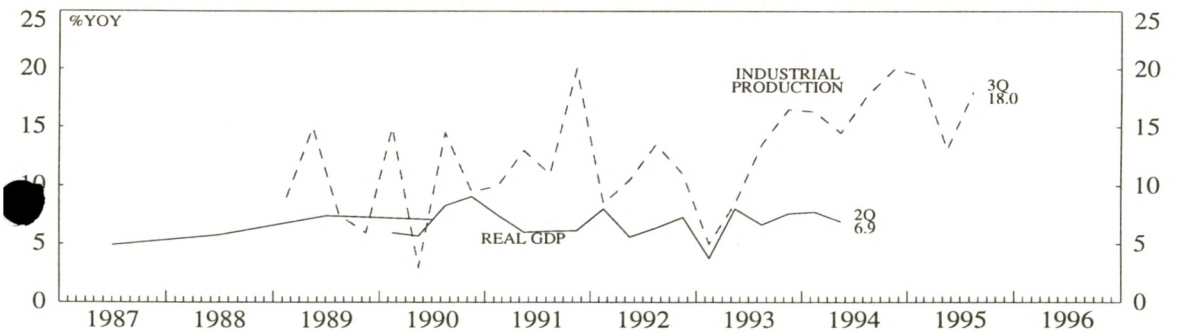
INDONESIA: MONEY MARKET AND BALANCE OF PAYMENTS

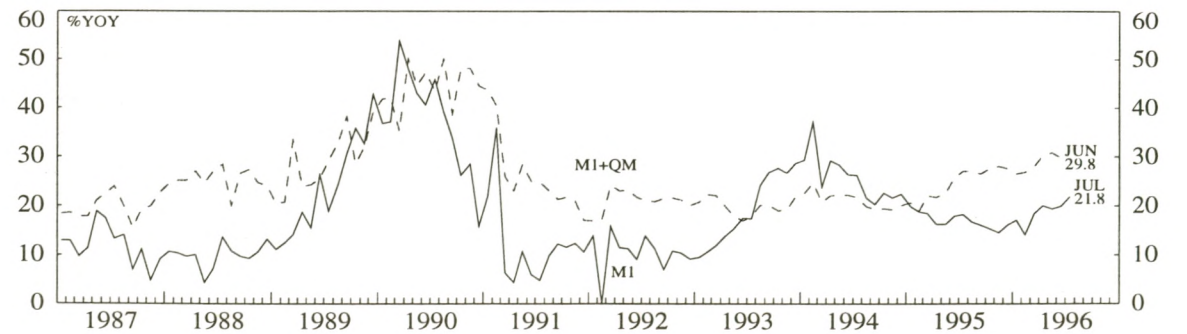


INDONESIA: MONEY, OUTPUT, GOODS AND ASSET PRICES





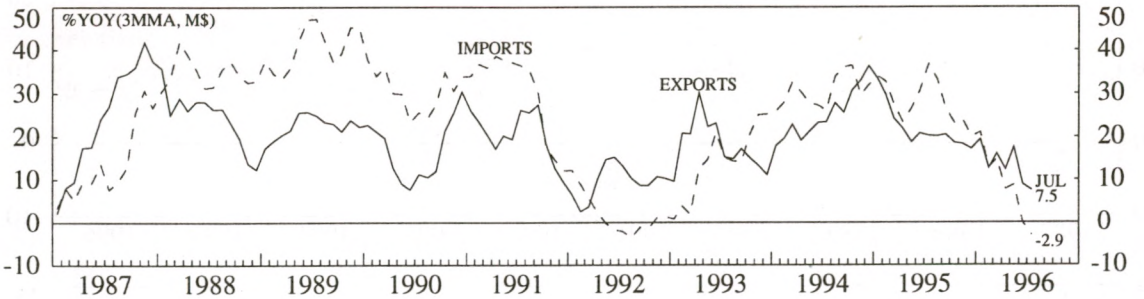


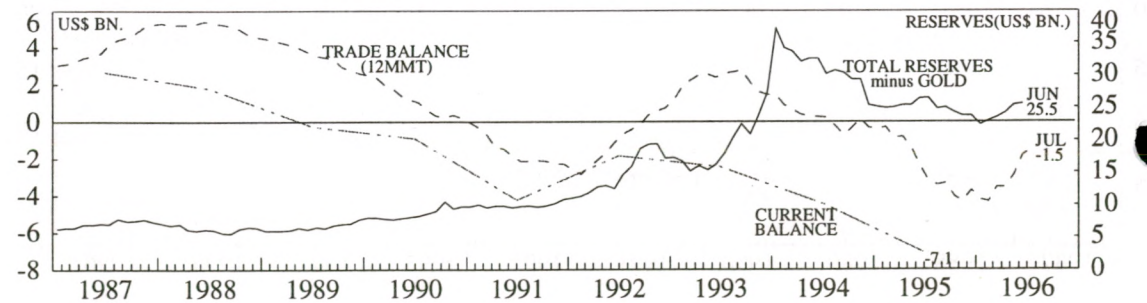


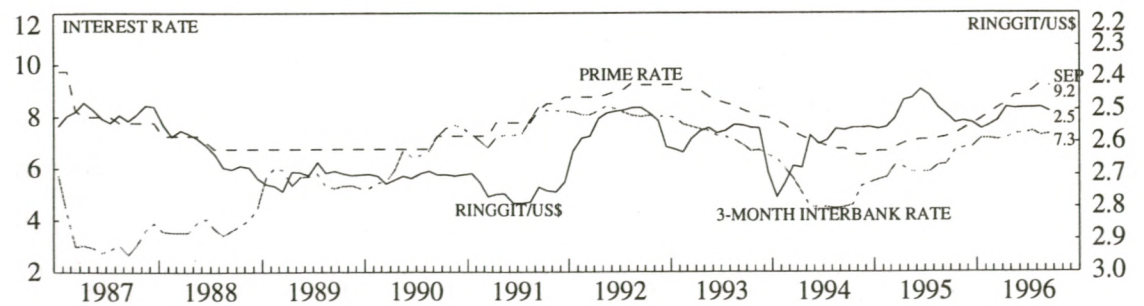
MALAYSIA: A TEMPORARY TRADE BALANCE IMPROVEMENT

Following steady improvement in the trade balance since March 1996, July numbers interrupted the trend somewhat by returning a sizeable trade deficit (RM 0.6 bn). The deficit in July was not unexpected. Malaysian trade numbers had earlier shown remarkable resilience to the export slowdown afflicting the rest of the region. Moreover, at least some of the trade balance improvement in local currency terms was attributable to the "J-curve" effect; the result of almost 3% Ringgit appreciation between January and April 1996. As OECD demand and the electronics cycle remain subdued, and alongside some ringgit depreciation in 1996H2, the trade balance can be expected to deteriorate once again over the remainder of 1996 and early 1997. While a slightly weaker Ringitt may in principle be limiting the scope for monetary policy easing, downward pressure on interest rates is, in practice, coming from the huge build-up in liquidity. Monetary growth is decelerating, but excess liquidity continues to find an outlet in credit expansion. BNM will remain alert, and ready to lean against, the threat of a re-acceleration in credit growth. On balance, a broadly unchanged monetary stance, and slower export growth, will have a dampening influence on the business cycle over the coming six months.

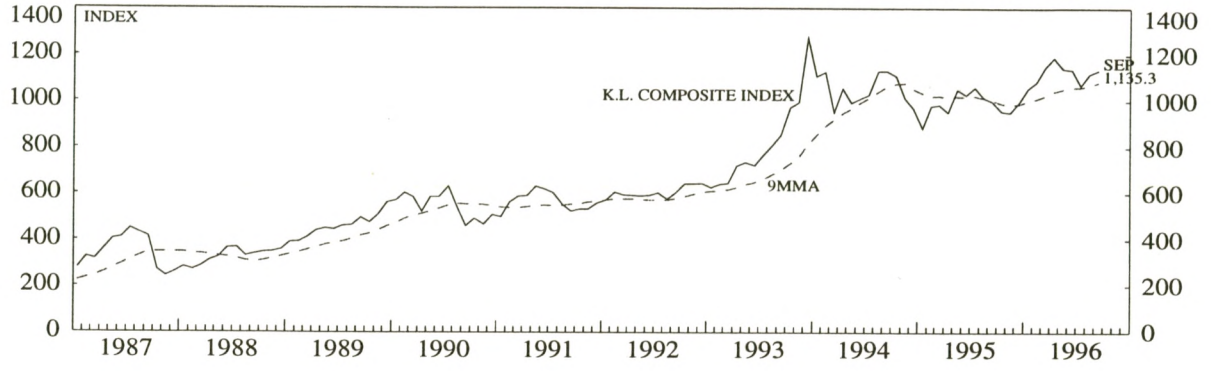
MALAYSIA: MONEY MARKET AND BALANCE OF PAYMENTS

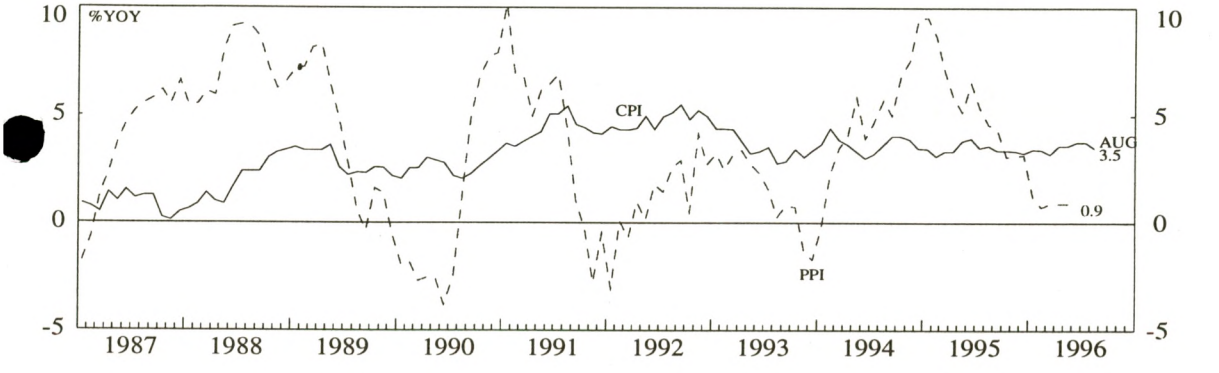


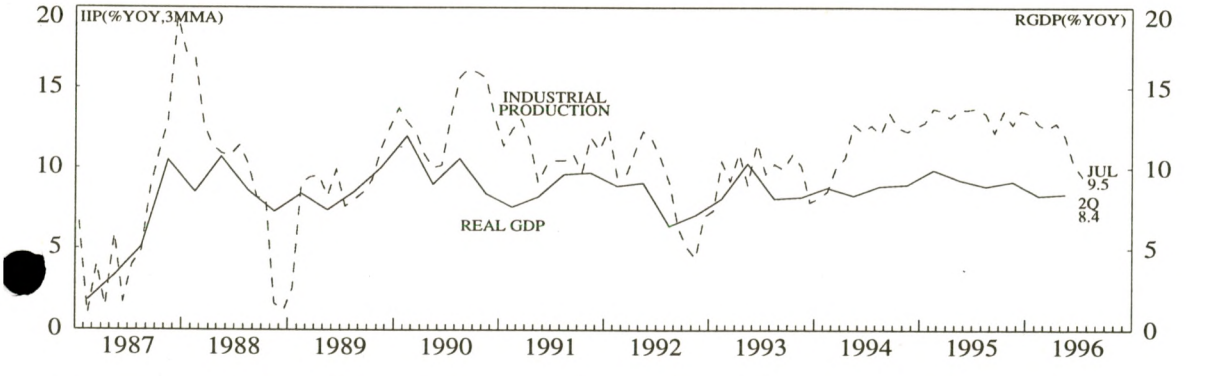


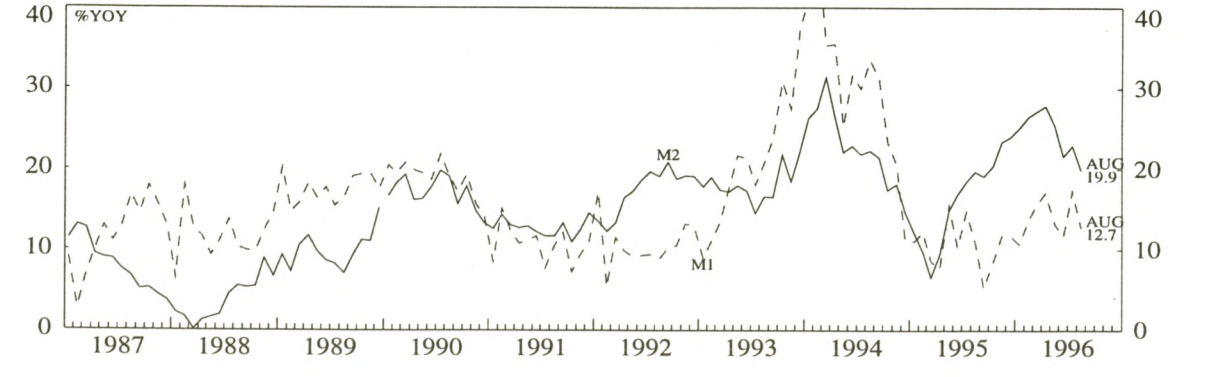


MALAYSIA: MONEY, OUTPUT, GOODS AND ASSET PRICES





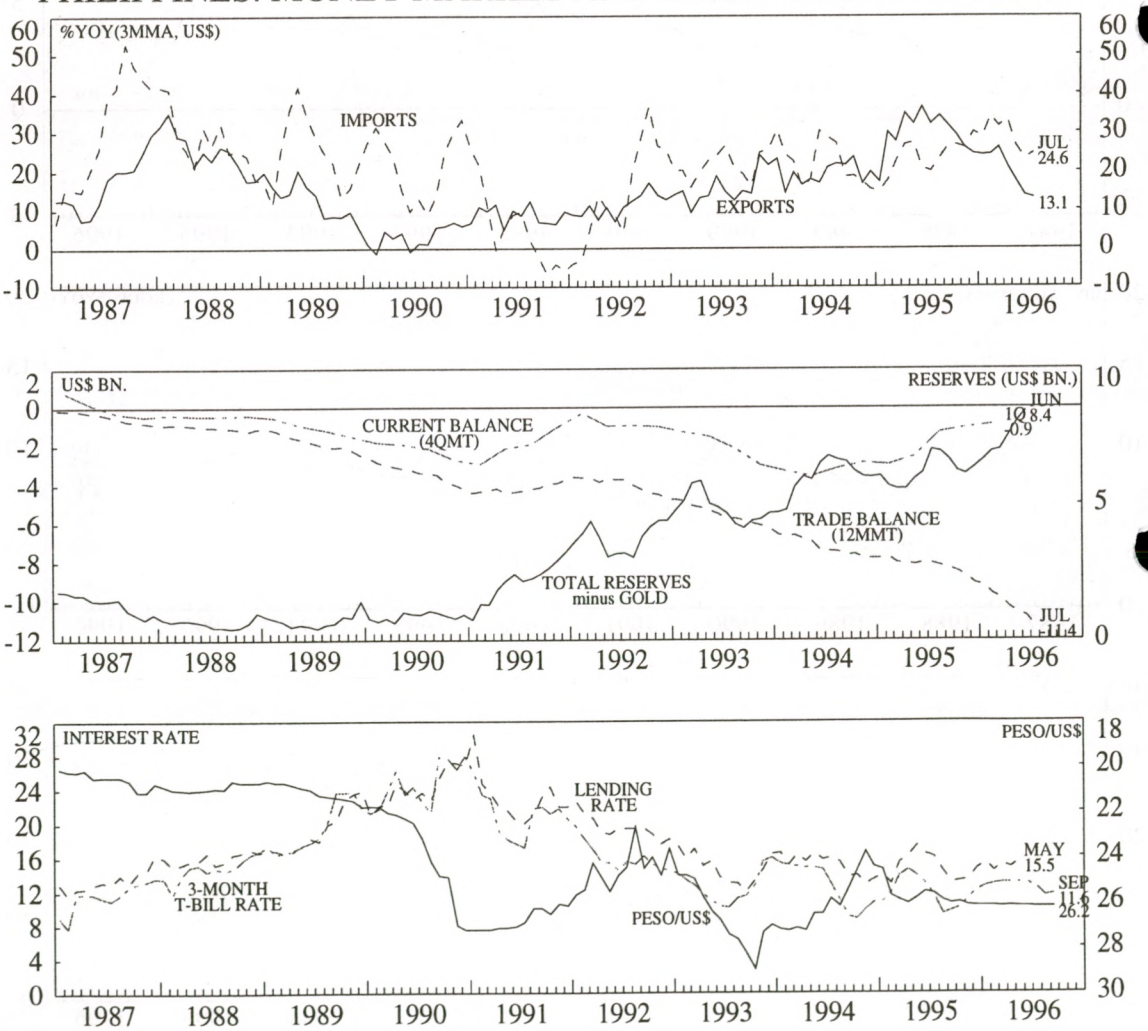




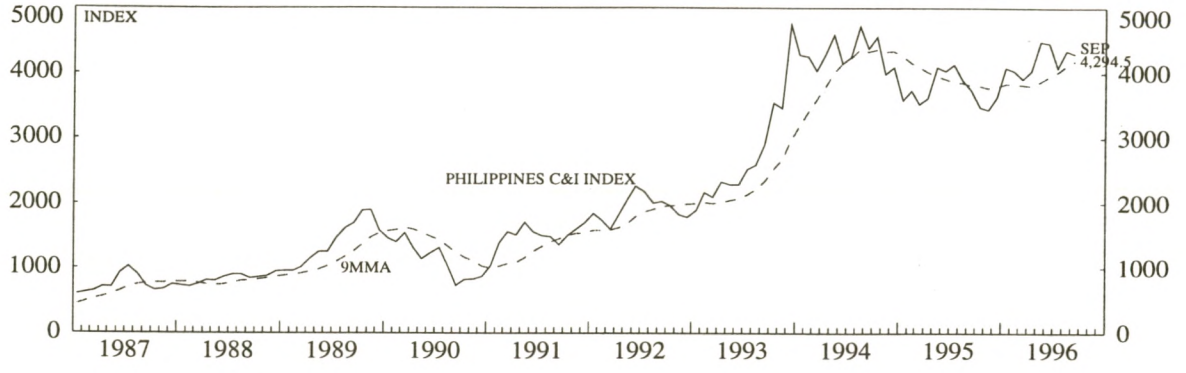
PHILIPPINES: CREDIT EXPANSION CONTINUES

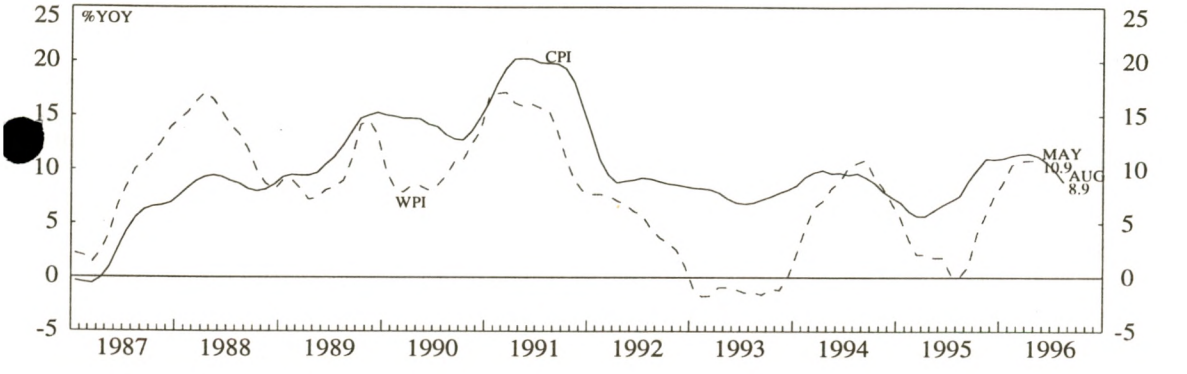
M2 growth has decelerated over the last 18 months to 21% in July. In part this deceleration reflects the high base in early 1995 when the effects of the cuts in reserve requirements were having their initial impact. However, this trend masks the relatively easy monetary conditions which have continued through most of this year as a result of the persistent inflows of foreign capital. Foreign exchange reserves have continued to accumulate to (US$10 bn in July) as the central bank has operated to keep the Peso/US$ stable in this environment. In recent months the central bank has tried to limit this source of monetary expansion by sterilising its foreign exchange intervention. However, 3 month interest rates currently remain stable at between 11-12% today, having declined from over 14% at the start of the year. In addition, bank credit growth has been very strong (46% yoy in March). These conditions augur for relatively buoyant economic growth in the coming 12 months despite the ongoing slowdown in export growth -- which itself will have a modest restraining impact on industrial production. The current weakness in export growth relative to that in imports will likely continue and contribute to further trade deficit deterioration in 1996.

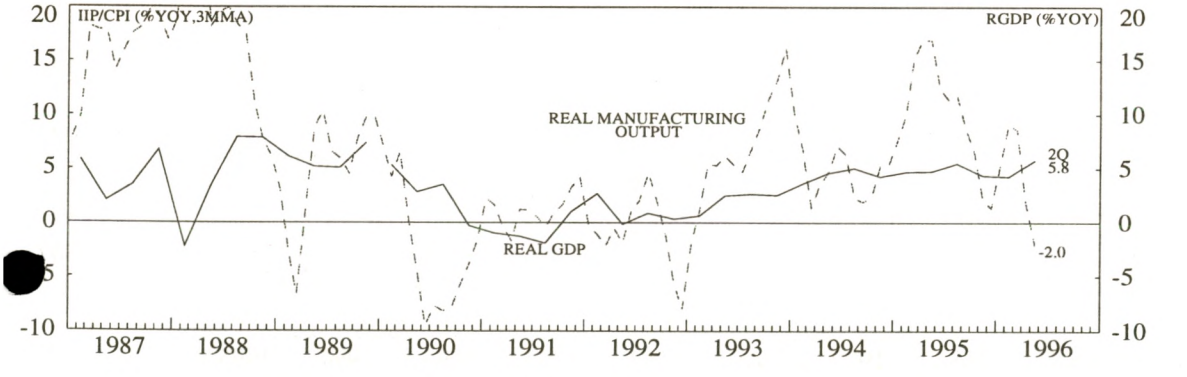
PHILIPPINES: MONEY MARKET AND BALANCE OF PAYMENTS

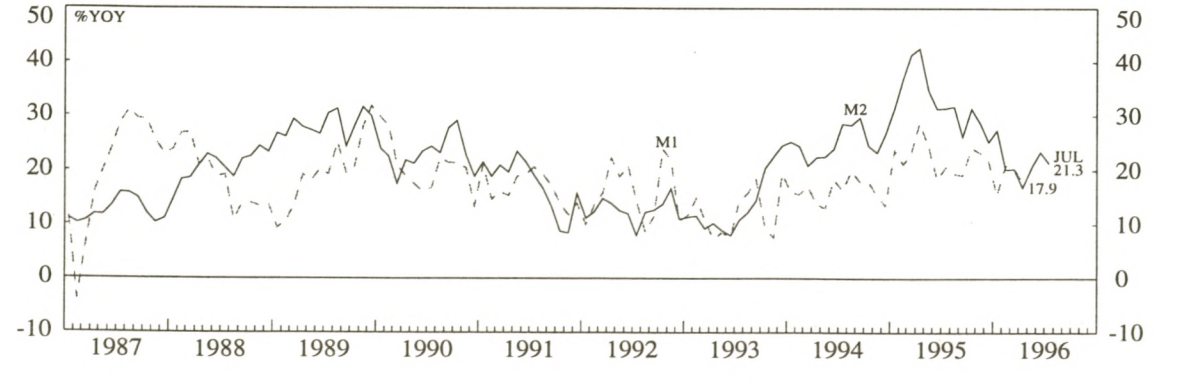


PHILIPPINES: MONEY, OUTPUT, GOODS AND ASSET PRICES





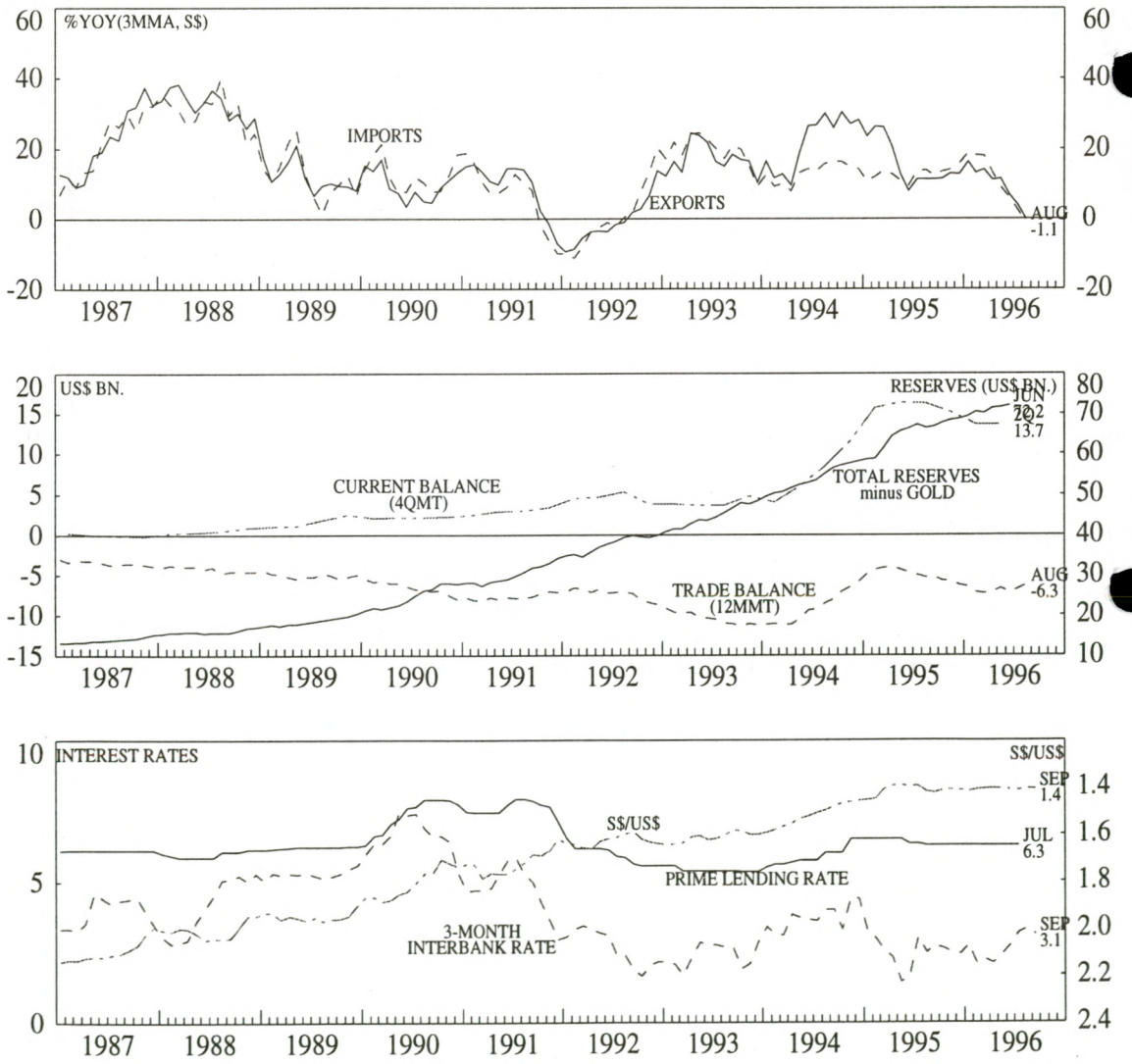




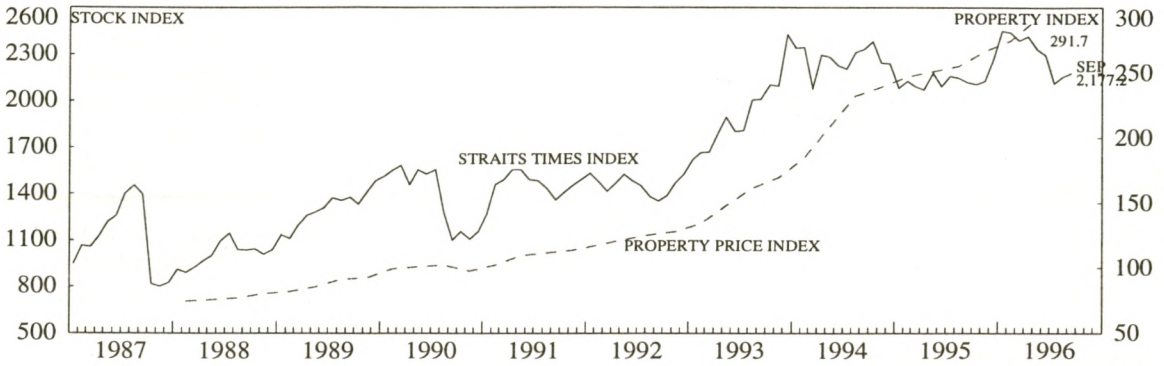
SINGAPORE: SLOWER ECONOMIC GROWTH AHEAD

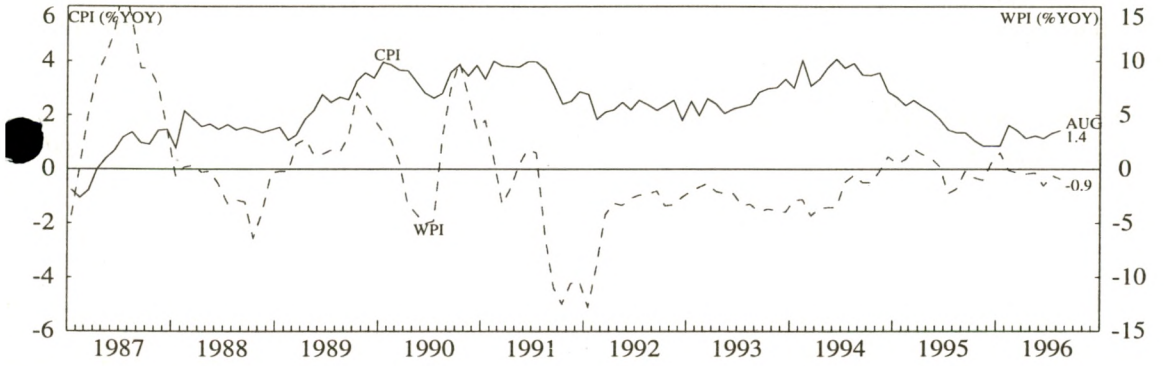
The Singaporean economy has been experiencing a period of slower economic growth generated by a decline in export demand. The downturn in semiconductor prices and demand in 1996 has dealt a significant blow to non-oil exports, around 35% of which are electronic parts or assemblies. The current slack demand conditions may continue to lead to slow export growth for most of the rest of this year. To a degree, this external slowing has been counteracted by buoyant consumer and private investment expenditures. The relatively firm domestic demand originates from the monetary expansion over 1994-95 and it continues to support healthy demand conditions in the residential and commercial property markets. However, over the last 12 months the authorities have moved to curb the rapid growth in consumer lending and imposed various controls to restrain the expansion in property values. Consequently, more subdued domestic economic growth along with the export downturn should combine to produce slower real GDP growth over the next 6 months.

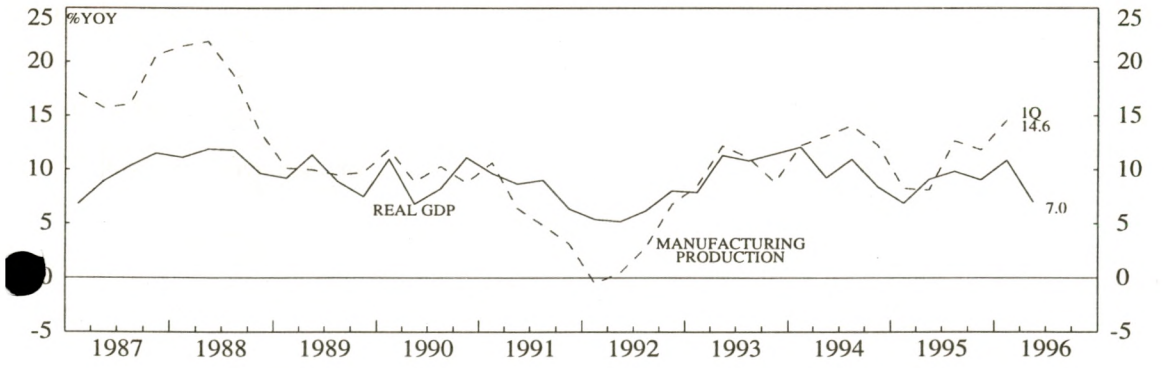
SINGAPORE: MONEY MARKET & BALANCE OF PAYMENTS

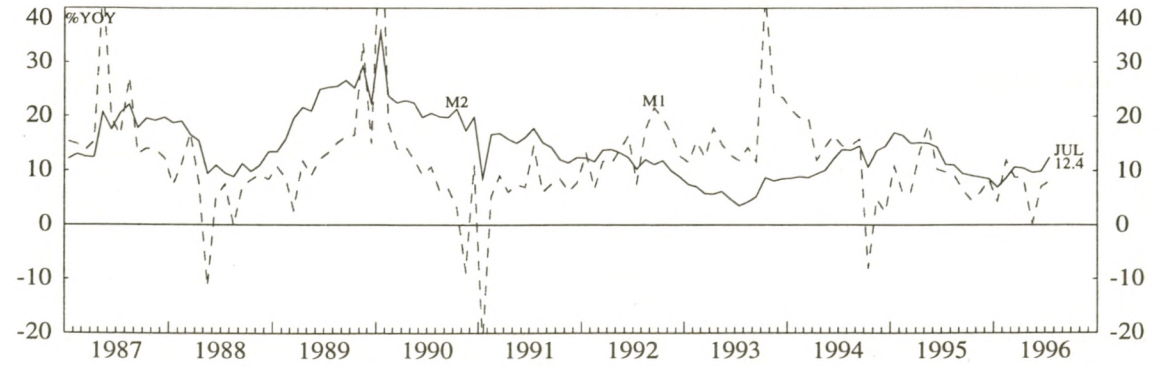


SINGAPORE: MONEY, OUTPUT, GOODS & ASSET PRICES





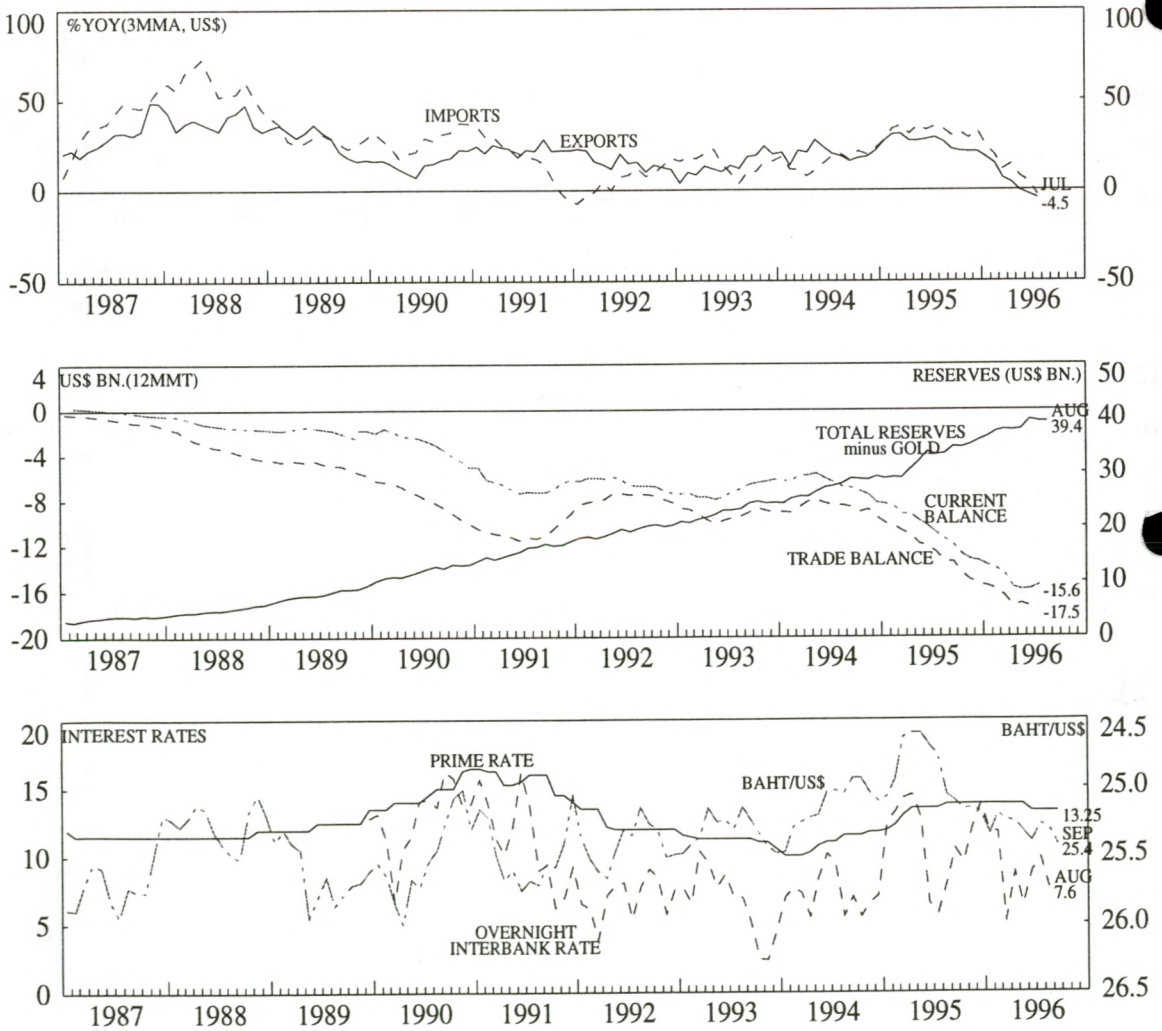




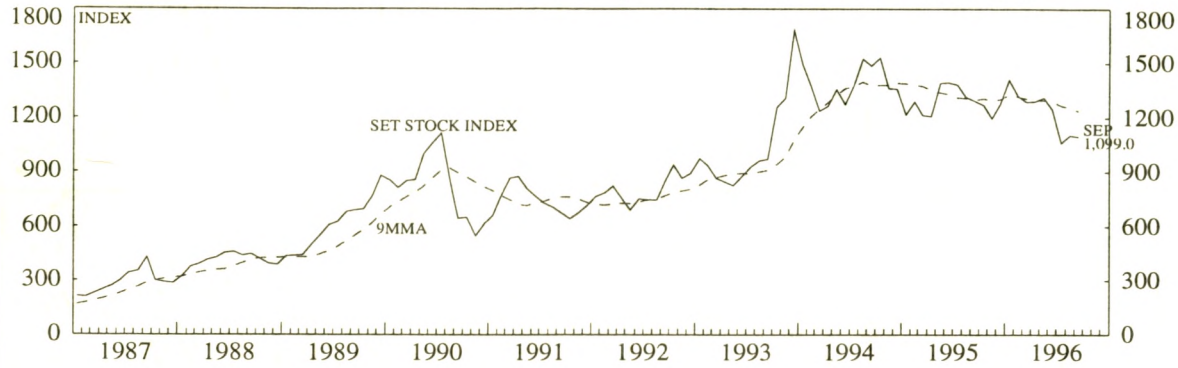
THAILAND: MONETARY EASING WILL BE CAUTIOUS

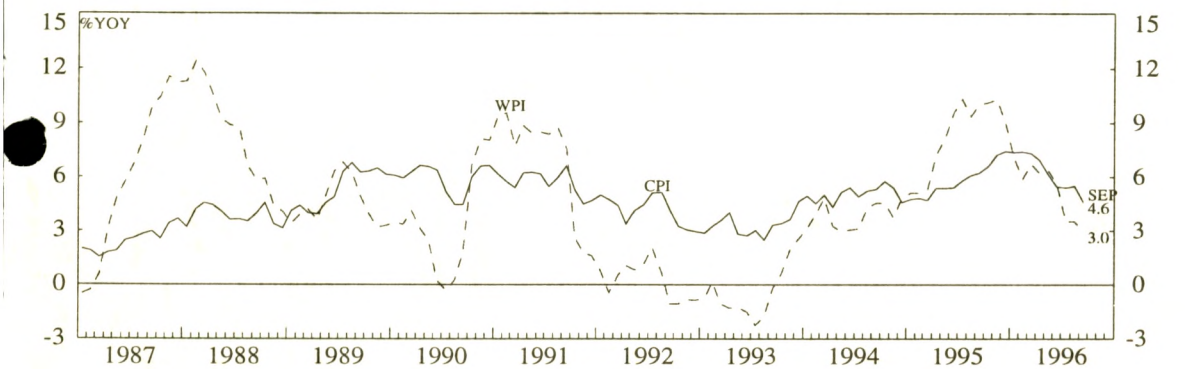
Recent industrial production data continue to show the Thai economy weakening significantly in 1996, as a result of both the collapse in export growth, and a prolonged period of monetary tightness. Exports contracted by 1.2% YoY in July 1996 while real interest rates have climbed as inflation has fallen, despite cuts in domestic prime rates over 1996. Nominal interest rates should ease further through 1996 and 1997, but the the moves are likely to be cautious, and probably timed to coincide with expectations of meaningful improvement in the trade balance. The extent and timing of any interest rate cuts is significant because capital inflows are also slowing; evidenced partly by the deceleration of M2. Speculative activity in the Thai Baht, especially in the wake of recent politcal turmoil, has not so far significantly affected the stock of foreign currency reserves or the value of the Baht against the US dollar. The combination of a weakening economy and the prospect of falling loan rates will not benefit financial institutions, which comprise a major portion of the Thai stockmarket index. Nevertheless, the market has fallen by some 20% over 1996, perhaps nearing a fair "discount" for the short-term growth concerns expressed above.

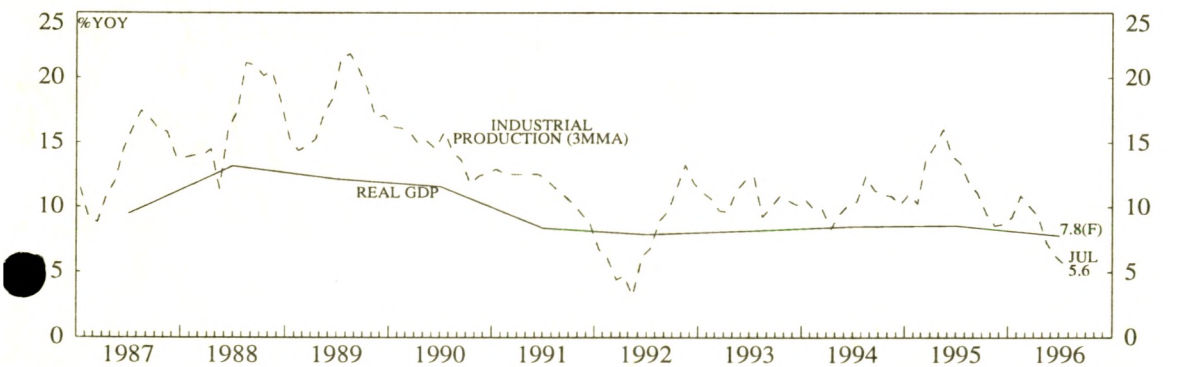
THAILAND: MONEY MARKET AND BALANCE OF PAYMENTS

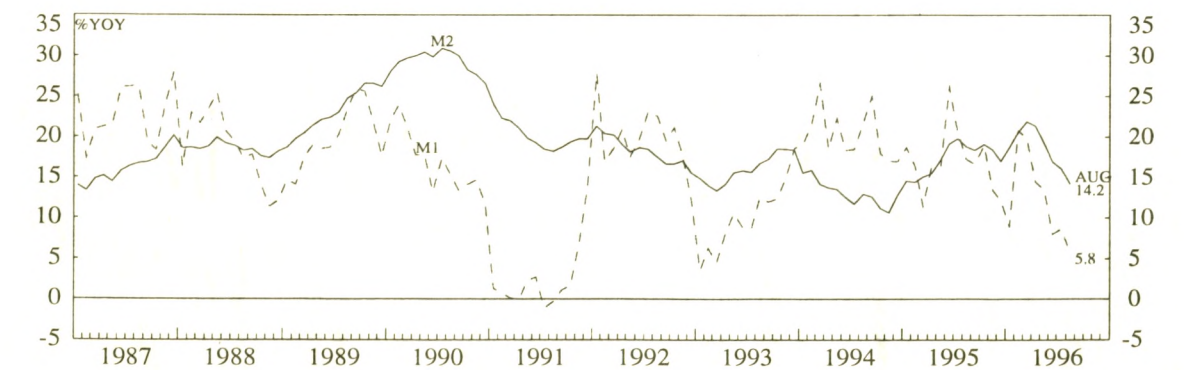


THAILAND: MONEY, OUTPUT, GOODS & ASSET PRICES









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ASIAN MONETARY MONITOR

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INDONESIA
A MINOR CHANGE IN CURRENCY POLICY?

Introduction.

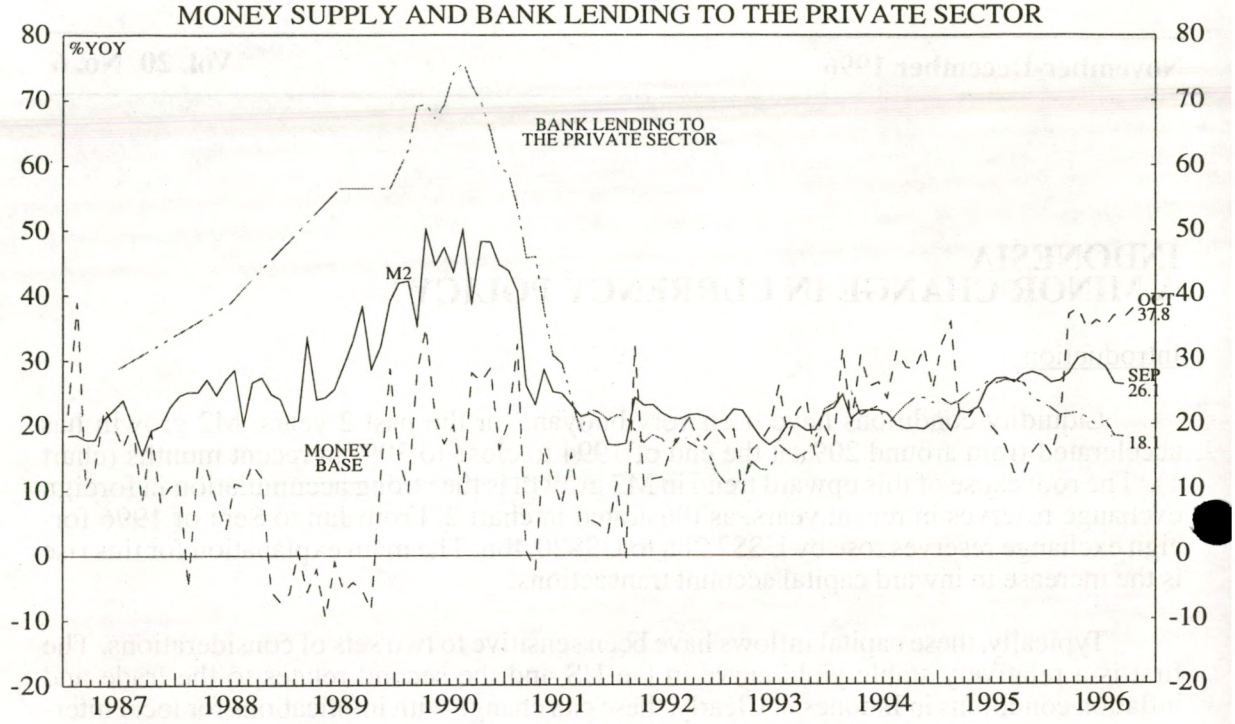
Liquidity conditions have been very buoyant for the past 2 years. M2 growth has accelerated from around 20% at the end of 1994 to close to 30% in recent months (chart 1). The root cause of this upward trend in M2 growth is the strong accumulation in foreign exchange reserves in recent years, as illustrated in chart 2. From Jan to Sept of 1996 foreign exchange reserves rose by US$2.2bn to US$20.4bn. The main explanation for this rise is the increase in inward capital account transactions.

Typically, these capital inflows have been sensitive to two sets of considerations. The first is a relatively stable yield curve in the US and the second relates to the trade and inflation conditions in Indonesia. Clearly, these can change with implications for local interest rates and asset prices, given the current exchange rate policy. However, for most of this year the central bank, Bank Indonesia (BI) have preferred to see local interest rates at a level higher than that implied by economic conditions. Consequently, there has been mounting speculation as to whether they will change the way in which the Rupiah is managed against other currencies. This short article evaluates the possibility of a change and concludes that a modest departure from current operating procedures is feasible.

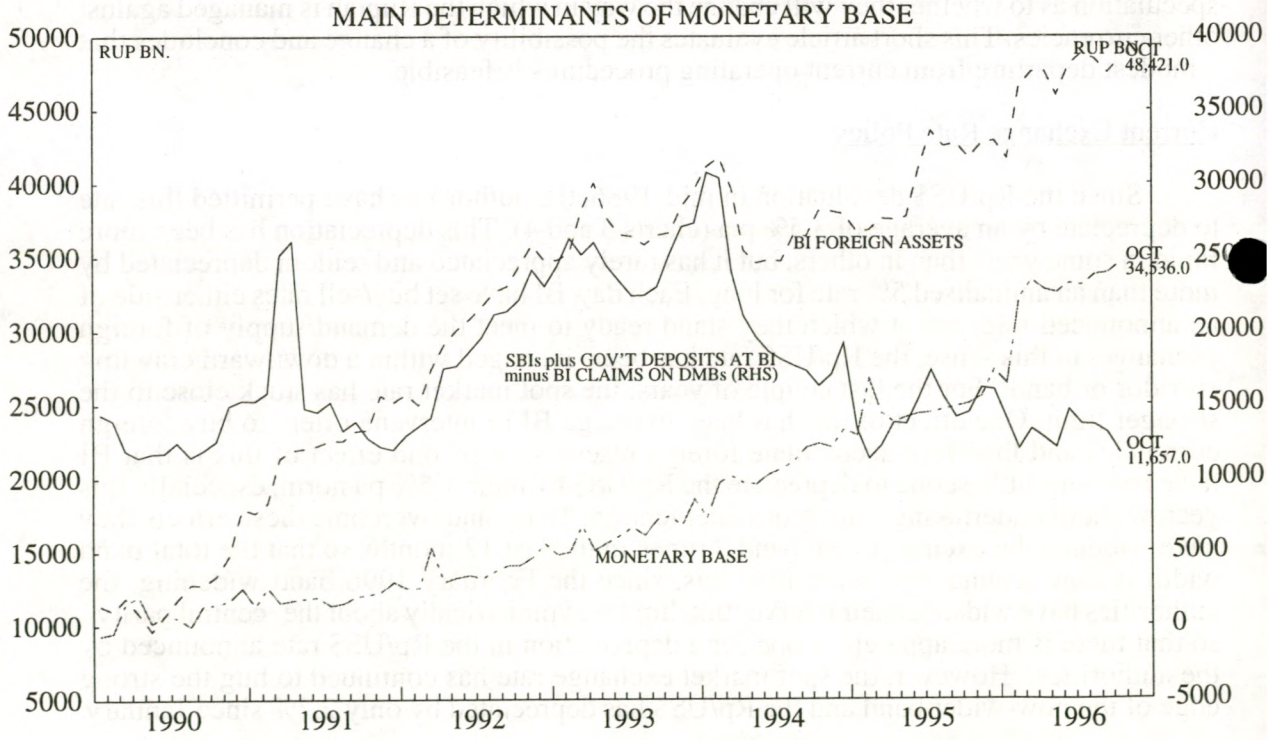
Current Exchange Rate Policy

Since the Rp/US$ devaluation in mid-1986, the authorities have permitted this rate to depreciate by an average of 3.5% p.a (charts 3 and 4). This depreciation has been more rapid in some years than in others, but it has rarely appreciated and seldom depreciated by more than an annualised 5% rate for long. Each day, BI have set buy/sell rates either side of an announced mid-rate at which they stand ready to meet the demand/supply of foreign exchange. In this sense, the Rp/US$ rate has been managed within a downward crawling corridor or band. For the last couple of years, the spot market rate has stuck close to the stronger limit. One effect of this has been to oblige BI to intervene often, to buy foreign currencies and therefore accumulate foreign reserves. A second effect of this is that BI have had very little scope to depreciate the Rp/US$ by their 3-5% pa norm, especially this year, without undertaking a lot more intervention. To try and overcome these effects they have widened the exchange rate band 3 times in the last 12 months so that the total band width is now around 8%. More than this, since the February 1996 band widening, the authorities have widened their intervention limits asymmetrically about the 'central parity,' so that there is more apparent scope for a depreciation in the Rp/US$ rate announced by the authorities. However, the spot market exchange rate has continued to hug the strong edge of the now-wider band and the Rp/US$ has depreciated by only 2.7% since January.

INDONESIA: CHART 1
MONEY SUPPLY AND BANK LENDING TO THE PRIVATE SECTOR



INDONESIA: CHART 2
MAIN DETERMINANTS OF MONETARY BASE



The authorities have tried to limit the stimulative impact of the influx in foreign capital by sterilising their foreign exchange intervention and by raising statutory reserve requirements (to be raised again to 5% by April '97). The solid line in Chart 2 shows the main elements of domestic monetary policy. These include: issuances of Bank Indonesia certificates (SBIs), BI money market lending and government deposits held at BI. When this line declines, BI has conducted more stimulative domestic monetary policy and vice versa. The level of monetary base jumps up at the start of 1996 in line with the hike in statutory reserve requirements at that time.

The Nature of a Currency Policy Change

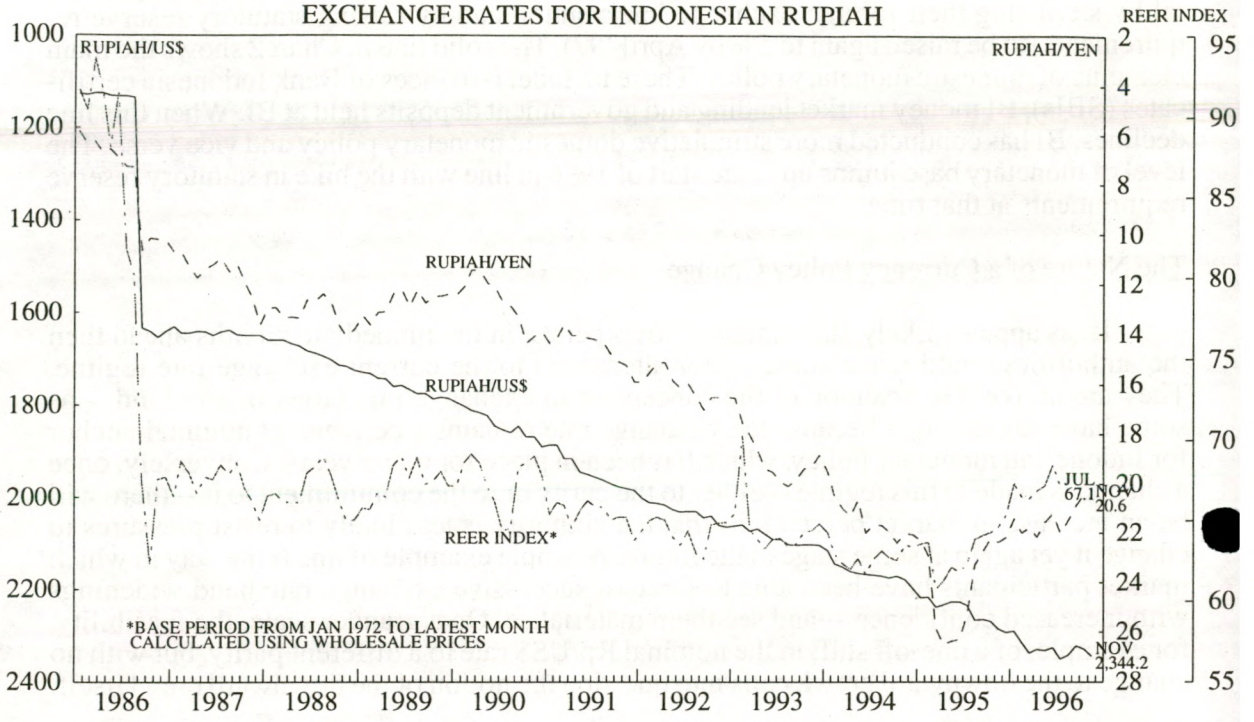
If, as appears likely, the capital inflows persist in the immediate months ahead then the authorities could make some minor alterations to the current exchange rate regime. They are unlikely to abandon of the concept of an exchange rate target of any kind -- as some have suggested -- because the exchange rate remains a convenient nominal anchor for Indonesian monetary policy, which has been in place for many years. Conversely, once a change is made to this regime -- either to the parity or to the commitment to it -- there will be an increase in market perceptions that the authority is less likely to resist pressures to change it yet again at some stage in the future. A simple example of this is the way in which market participants have been able to forecast successive exchange rate band widenings with increased confidence -- and see them materialise. On a grander scale, the feasibility, for example, of a one-off shift in the nominal Rp/US$ rate to a different parity, but with no change to the downward crawl, calls into question the notion of the downward crawl itself.

A minor change that the authorities could make without sacrificing too much credibility of the current regime would be to target a steady Rp/US$ rate for the year ahead and not one that is expected to be subject to downward adjustment by the authorities. Throughout most of 1996 one could argue that this has already happened, albeit initially unintentionally. However, the authorities have not made a stable Rp/US$ rate an explicit element of their exchange rate policy yet. In addition, widening the exchange rate band of intervention further still, would build in greater exchange rate flexibility, in theory. However, in practice the widening so far has resulted in a continuous 'test' of the stronger side of the band by currency traders (chart 4).

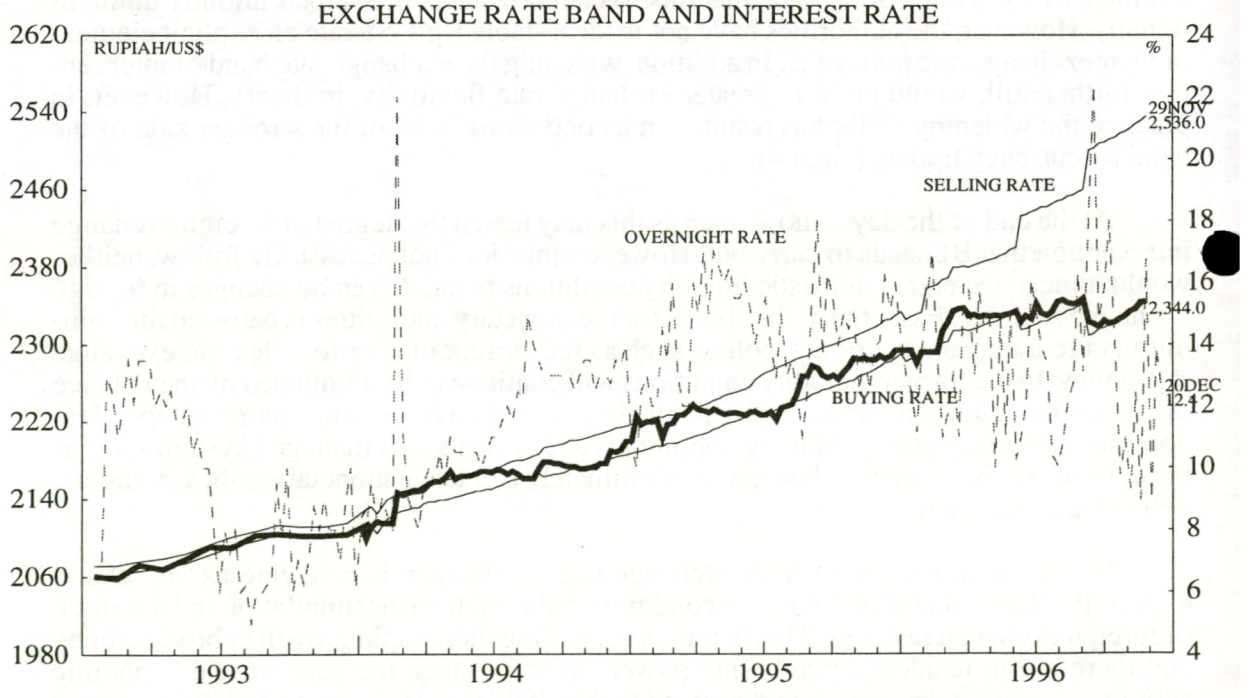
At the end of the day, a move such as this may lessen the degree of foreign exchange intervention that BI needs to carry out. However, this does not necessarily follow, neither would it mean the end to domestic liquidity conditions being driven by changes in foreign exchange reserves. Essentially, the choice for the monetary authorities is between the commitment to a managed currency policy, such as the current one, or to a flexible exchange rate policy. In the former, liquidity conditions will continue to be dominated by the balance of payments condition, while in the latter they would have to adopt more independent domestic monetary policy. Making continuous adjustments to a managed system such as the current one is a half-way house which ultimately can leave monetary policy without a defined nominal anchor.

In the meantime, the current exchange rate mechanism is behaving as one would expect. Positive balance of payments conditions have led to an accumulation in BI's stock of foreign exchange reserves. This in turn is generating more rapid growth in broad money and therefore in resident's purchasing power. At some stage the pace of real economic activity and import demand should respond to this. If this leads to a sustained deterioration in the trade balance, then the premium to holding Rupiah will rise. This could then give rise

INDONESIA: CHART 3
EXCHANGE RATES FOR INDONESIAN RUPIAH



INDONESIA: CHART 4
EXCHANGE RATE BAND AND INTEREST RATE



to capital movements which deplete BI's foreign exchange reserves and lead to slower M2 growth. Interest rates will then rise. So far this year, the trade deficit has not deteriorated as much as might have been expected from the negative export trends, because imports have followed suit. Another major (and difficult to predict) indicator that affects the premium foreign investors attach to holding rupiah assets is the rate of inflation. The sequence of events described above should also be expected to bring a rise in the rate of inflation further ahead. However, in the nearterm this rate has come down and will stay more subdued in the months ahead while the base effects of lower import prices drop out. In addition to these local considerations, a steepening US yield curve or tightening in US monetary policy has tended to have a greater impact on the premium to holding Rupiah than changes to local conditions. A good example of this is the decline in foreign exchange reserves and rise in local interest rates back in early 1994 (charts 2 and 4).

SUMMARY AND CONCLUSIONS: There is unlikely to be any major change to Indonesia's exchange rate policy although a minor change to the rate of Rp/US$ depreciation is possible. Specifically, the authorities could announce a stable outlook for the Rp/US$ for the next year. This would not necessarily spell the end to the ongoing monetary expansion, but may lead to a more moderate accumulation of foreign exchange reserves. Another possibility is for the authorities to widen their intervention band for the exchange rate further. Yet another route, that they have already begun to pursue, is to leave the exchange rate regime relatively untouched and allow internal interest rates to come down to market clearing levels, while implementing more heavy-handed direct controls on credit.

JAPAN
PROFITABILITY AND PRICING POWER

With the interim reporting season for Japanese companies just concluded, it seems an appropriate juncture to take stock of Japan's corporate profit recovery. This article attempts to review what has driven the recovery in Japanese profits to date and to assess whether these factors can drive corporate profit growth in the future or whether more fundamental change will be needed.

Differing Data for Corporate Profits

There are numerous sources for data on corporate profits in Japan. The choice of source and sample has a huge impact on the growth rate of the aggregate, with different market aggregations resulting in widely differing results. The biggest uncertain factor is undoubtedly the financial sector, which is still in the process of repairing balance sheets damaged by bad loans extended during the bubble economy and subsequently gone sour. The true scale of the problem is still uncertain, with independent estimates of banks' bad loans varying widely between 30 and 80 trillion yen. Given the high weight of financials in Japan's stockmarket indices, the rate at which they resolve their bad loan problems and the colour of their bottom line turns from red to black will obviously have a huge impact on aggregate corporate profits. Given this major element of uncertainty, most observers focus on the aggregate profits of the non-financial sector, which follows more closely the performance of the economy.

However, even for non-financials, there are differences in samples and occasional changes in accounting practices which need to be borne in mind. The Nikkei aggregation of corporate profits, for instance, excludes companies which had changed financial year-end within the past two years, thereby omitting the rapidly growing profits of Toyota Motors, and yielding a lower aggregate profits figure than other data providers. A special factor this year is the change in accounting practices of wholesale trading companies to exclude precious metals trading from total revenues, but still include the profits from such activities, thereby boosting profit margins (profits as a percentage of sales). Historic cost accounting in Japan, along with relatively high capital gains taxes, opens the possibility of smoothing profits through careful use of hidden reserves, as is evident in the differences between the Japanese and US-style accounts of some of those Japanese companies with dual stock exchange listings.

One way to deal with outliers, anomalies and other 'difficult' observations is to eliminate them from the sample. While this approach may be useful for a securities house to focus on the universe of stocks they actually research, it reduces its usefulness from a statistical point of view (fewer degrees of freedom) and from a macro-economic point of view (smaller proportion of overall economy).

Another approach is to widen the scope of the profit aggregation. The MoF (Ministry of Finance) Corporate survey covers all (now over 700,000) non-financial companies with paid-in capital of more than 10 million yen, provides a comprehensive source of detailed quarterly data going back 20 years, and correlates well with macro-economic variables. It does have a few problems. The number of companies increase every year as more companies make it above the 10 million yen capital threshold causing an upward sample-size bias on growth rates of profits, while the myriad of smaller companies have little in common with the investment opportunities available in the stock market. However, the MoF Corporate Survey is subdivided by company size, with the group of large companies

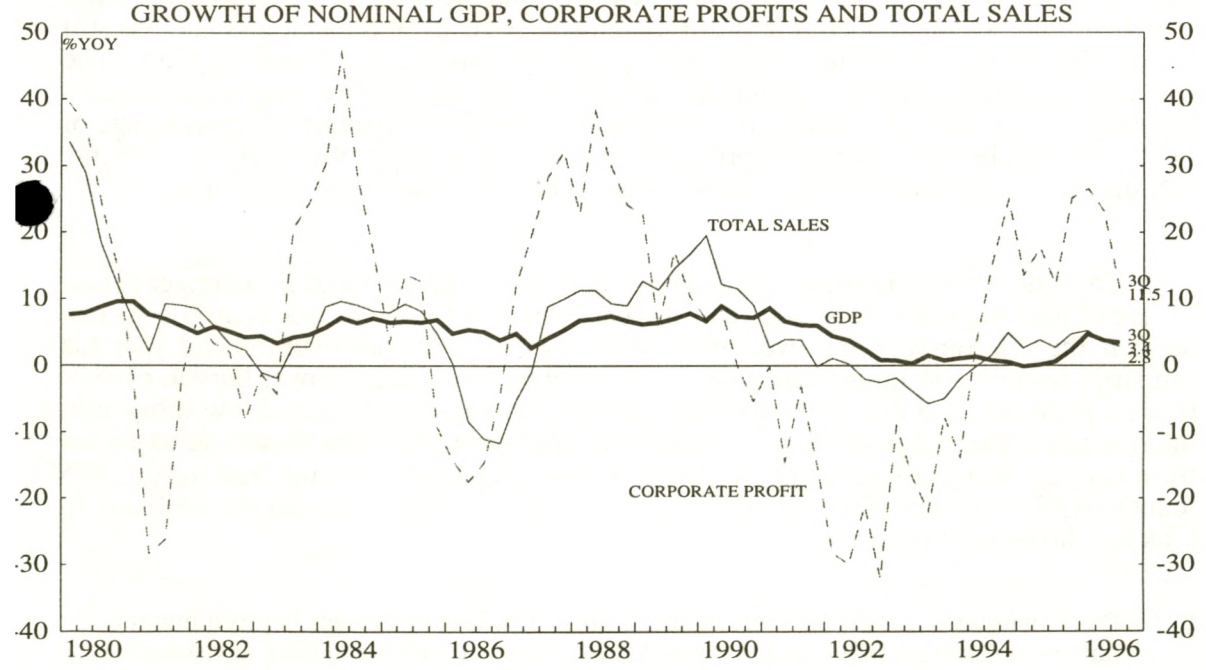
(capital of more than yen 1 billion) suffering from less sample-size bias, being still correlated with macro-economic data, and being similar to actual investment opportunities in the stock market. For these reasons, our analysis of corporate profits below is based on the MoF Corporate Survey data for economy-wide non-financials with capital of more than 1 billion yen - a universe now covering over 5000 companies.

What drives profits?

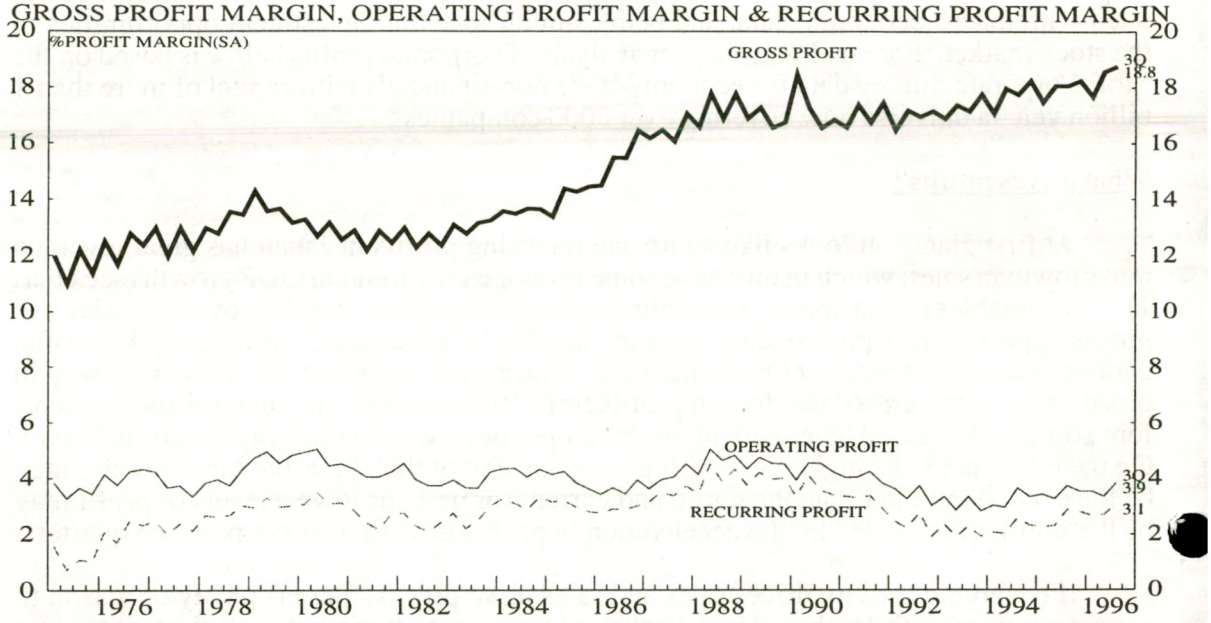
At first glance, it looks like aggregate recurring profits in Japan has great leverage into growth in sales, which in turn have some leverage into nominal GDP growth (see chart 1). The variables do not appear to be entirely coincident, as the recent recovery in sales and profits appear to have preceded the upswing in GDP by 1 1/2 years. Eyeballing the profits data one can draw a number of conflicting conclusions. One is that the recent recovery in profits has not yet erased the drop in profits from 1990 to 1994, and that profits are therefore still at a depressed level with plenty of scope for recovering to a higher normal level. On the other hand, the higher level achieved at the end of the 1980s bubble economy may be the exception rather than the norm, and current (or perhaps lower) levels of profit may be the norm, as indicated by the deceleration in profits growth over the past two quarters.

If economic activity drives sales and sales drive profits, there is plenty of reason to expect profit growth to slow down further, almost no matter what school of economic thought you come from. From a monetary point of view, broad money supply (M2+CDs) growth has been stable at 2-4% for over two years, which (given the downward trend in income velocity of circulation) suggests a deceleration in nominal GDP growth to around 2% over the next year or so. Another monetary indicator, the yield curve, also suggests a deceleration in economic activity. From a Keynesian point of view there is even more cause for concern given the government's planned increase in consumption tax from 1 April 1997, and the prospect of further fiscal consolidation given the stretched nature of

JAPAN: CHART 1
GROWTH OF NOMINAL GDP, CORPORATE PROFITS AND TOTAL SALES



JAPAN: CHART 2
GROSS PROFIT MARGIN, OPERATING PROFIT MARGIN & RECURRING PROFIT MARGIN



public finances. Both government and private sector forecasts have recently been revised down considerably, with the government forecasting 1.9% real GDP growth for the fiscal year to March 1998, versus consensus forecasts averaging 1.5% and ranging from 0.7% to 2.0%. All in all little reason to expect economic growth to drive growth in sales. Therefore further profit growth will have to come from improvements in profit margins.

When looking at profit margins* it is clear that different lines tell different stories (see chart 2). Recurring profit margins are still below the bubble peak, but just above the long-term historical average, operating profit margins have recovered much less and are still below their historical average, while gross profit margins are at a historical high. The widening gap between rising gross profit margins and virtually flat operating profit margins represents rising Sales, General and Administrative (SG&A) expenses as a percentage of sales. The gap between operating profit margins and recurring profit margins represents non-operating expenses, which in Japan's case in mainly interest and other financing expenses.

To explore what has driven the recovery in recurring profit margins in greater detail, let us examine in greater detail the year-on-year basis-point changes (see chart 3). As can be seen, the year-on-year improvement in recurring profit margins over the past year has primarily been due to improvements in non-operating items, i.e. a lower burden of debt interest payments and discount expenses over the past year due to record low short-term interest rates. The scope for further reductions in interest and other financing expenses from here on in appears very limited, and as a year has passed since the September 1995 reduction of the official discount rate to 0.5%, the year-on-year comparisons are likely to look less favourable from now on.

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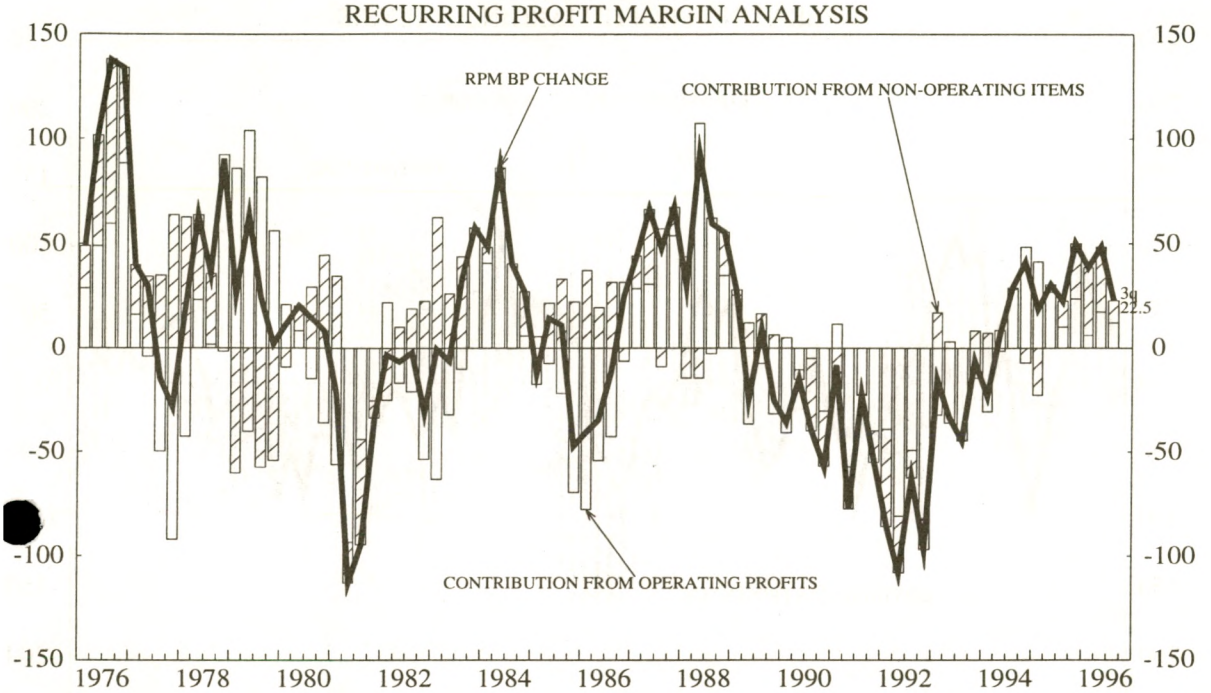
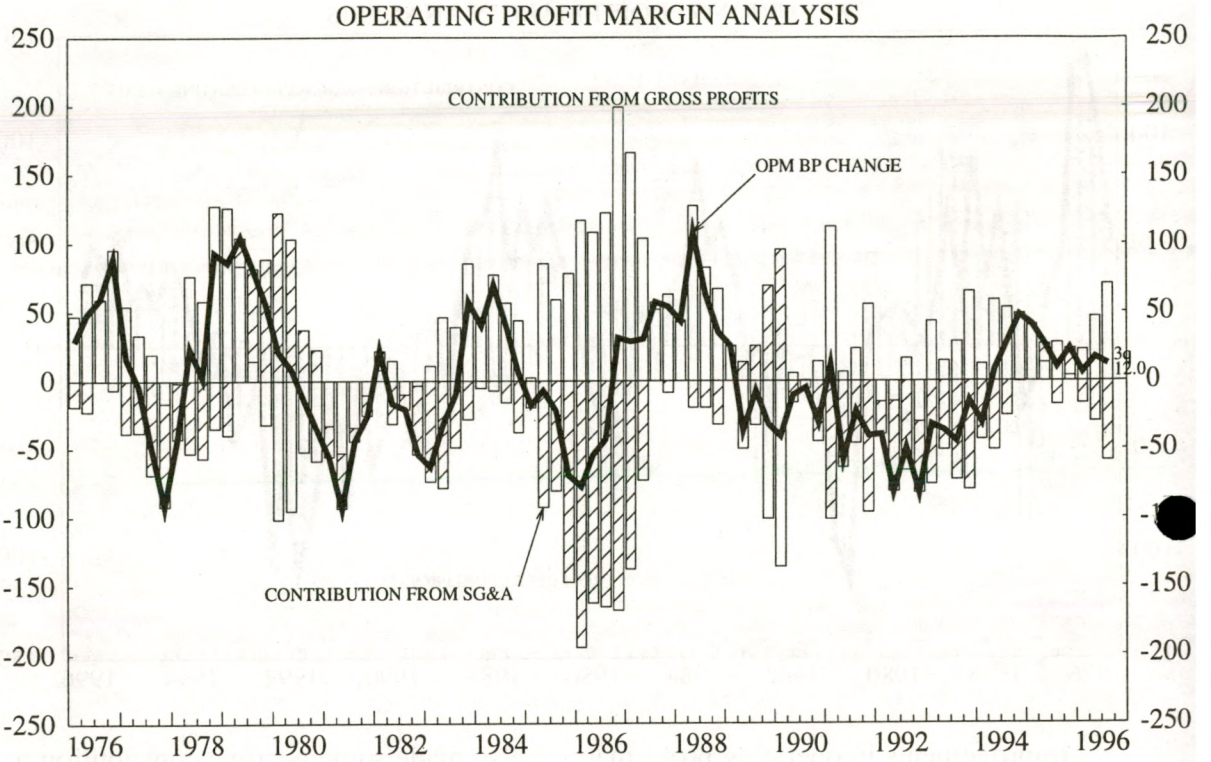
JAPAN: CHART 3
RECURRING PROFIT MARGIN ANALYSIS



Improvements in operating profit margins also made some positive contribution to recurring profit margin expansion, especially from mid-1994 to mid-1995. How did Japanese companies manage to improve their operating profitability during this period? As shown in chart 4, almost all of the improvement in operating profit margins has been due to improvements in gross profit margins. SG&A expenses, on the other hand, have made a significant negative contribution to operating profit margins during the first half of the 1990s. Improvements to profit margins as a result of trimming of cost structures would be expected show up as positive contributions from controls of SG&A expenses. Such evidence of restructuring is only evident briefly in 1995.

What has driven the improvement in gross profit margins to new highs? Gross profit is the difference between sales and cost of goods sold. Improving gross profit margins indicate that output prices rise relative to input prices. This is corroborated by the relative movements over long time periods of Japan's myriad of price indices: manufacturer's output prices have risen relative to input prices (see bottom panel of chart 5) and consumer prices have risen relative to wholesale prices. What has driven this sustained shift in intersectoral terms of trade in favour of the corporate sector? One contributing factor is undoubtedly the exchange rate, which correlates reasonably well with gross profit margins (see top panel of chart 5). An ever-rising yen meant ever-falling costs of imported inputs. These reductions in import prices were never fully passed onto domestic consumers, and only slowly reflected in domestic wholesale prices (see chart 6). Since Spring 1995 the weakening of the yen and (more recently) the increase in some commodity prices have put significant upward pressure on import prices. Domestic wholesale prices, however, continue to fall and show no sign of rising yet. Unless Japanese companies are able to pass on the increase in input costs, we should therefore expect that the recent exchange rate depreciation will have a significant negative impact on gross profit margins.

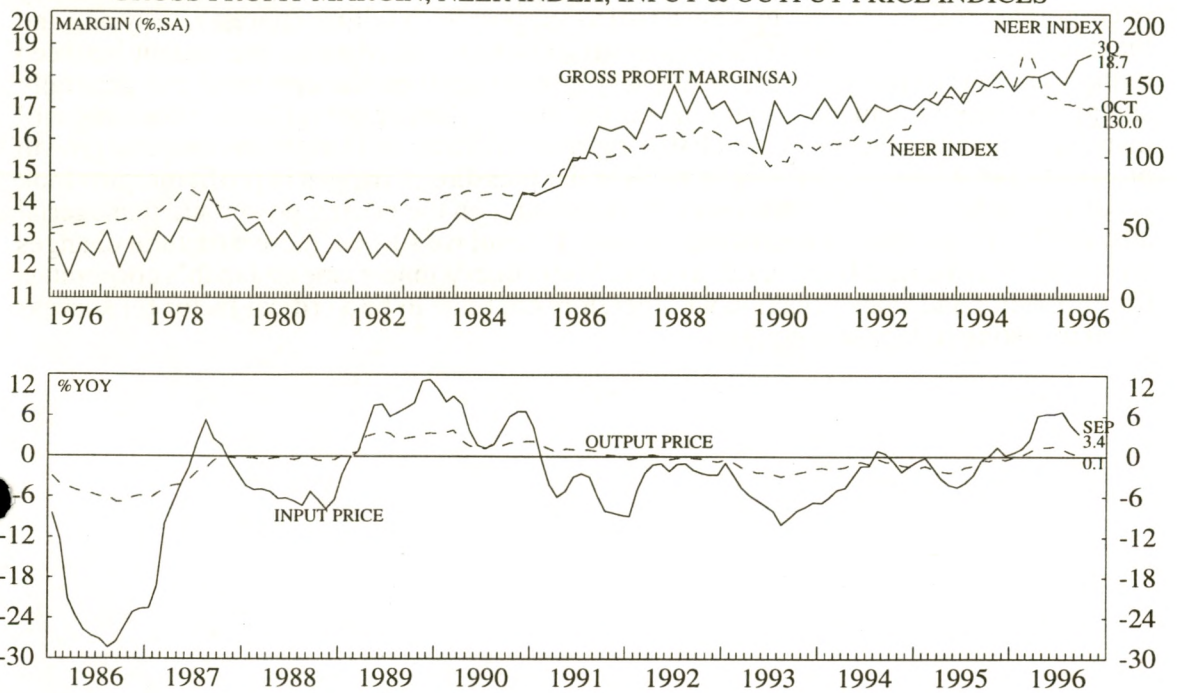
JAPAN: CHART 4
OPERATING PROFIT MARGIN ANALYSIS



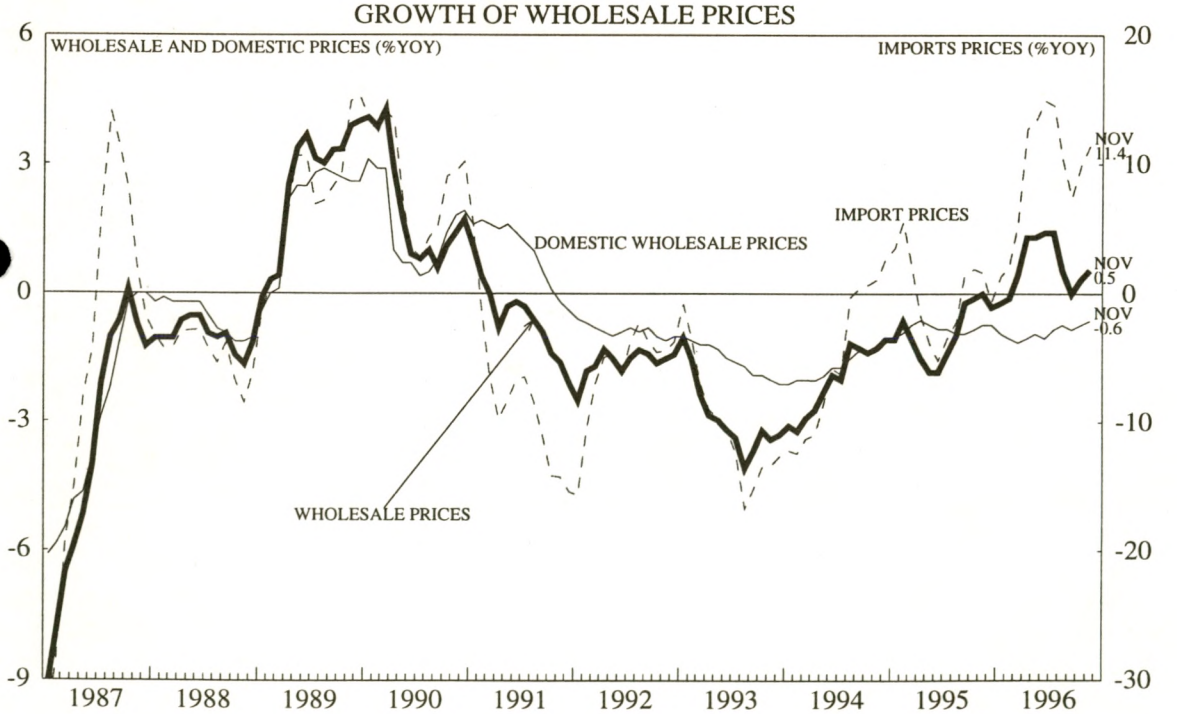
The pricing power of Japan's corporate sector, i.e. its ability to pass on the rise in input cost and avoid a squeeze to their profit margins, will depend on supply/demand conditions for the economy in aggregate and for each individual sector. The absence of a more serious squeeze in gross profit margins for the universe of companies analysed above suggests that they have had some pricing power. However, such pricing power has not been evident in consumer prices, which have remained remarkably stable. Rather, pricing power has been exercised in relation with other, generally smaller, companies. Repeating the above anlaysis of changes in profit margins for smaller companies (i.e. the remainder of the MoF Corporate Survey universe) reveals a far more severe margin squeeze, which has forced far more severe curtailment of SG&A expenses. In other words, large companies have cut costs not by cutting their own SG&A cost base but by forcing their smaller suppliers to accept lower prices and cut their production and overhead costs. The extent to which this can continue without some negative impact on aggregate demand (as smaller companies account for the bulk of employment in Japan) may be limited.

Pricing power varies immensely from sector to sector. In the Appendix we have compiled indicators of pricing power and profit margins for some of the main sectors. As shown, the transportation, electrical and precision equipment industries have enjoyed significantly greater pricing power than the basic commodities. Petroleum and coal products in particular have been badly squeezed with the price of oil more than doubling in yen terms since mid-1995, while the retail price of gasoline in Japan has fallen sharply as imports have been deregulated.

JAPAN: CHART 5
GROSS PROFIT MARGIN, NEER INDEX, INPUT & OUTPUT PRICE INDICES

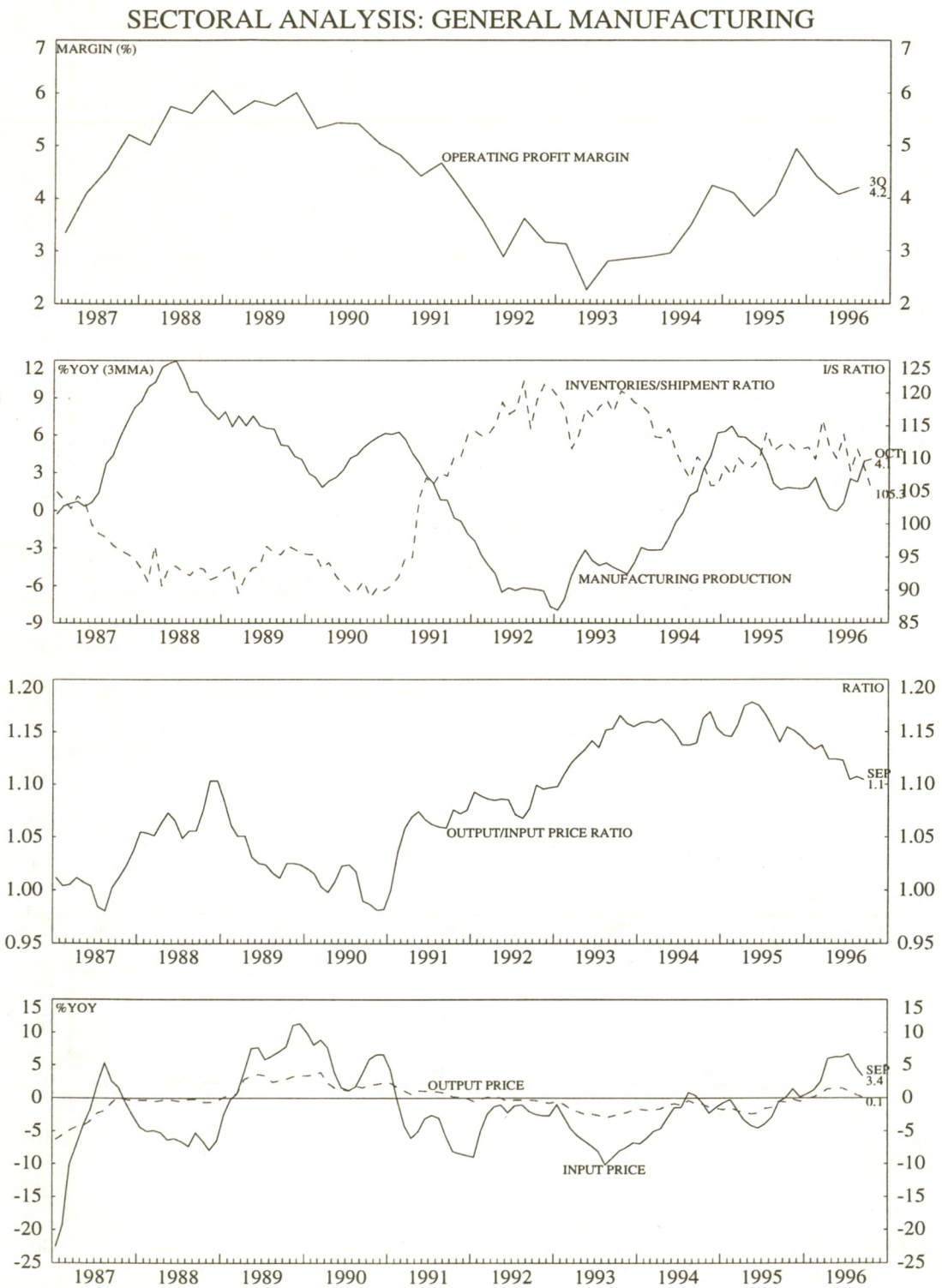


JAPAN: CHART 6
GROWTH OF WHOLESALE PRICES

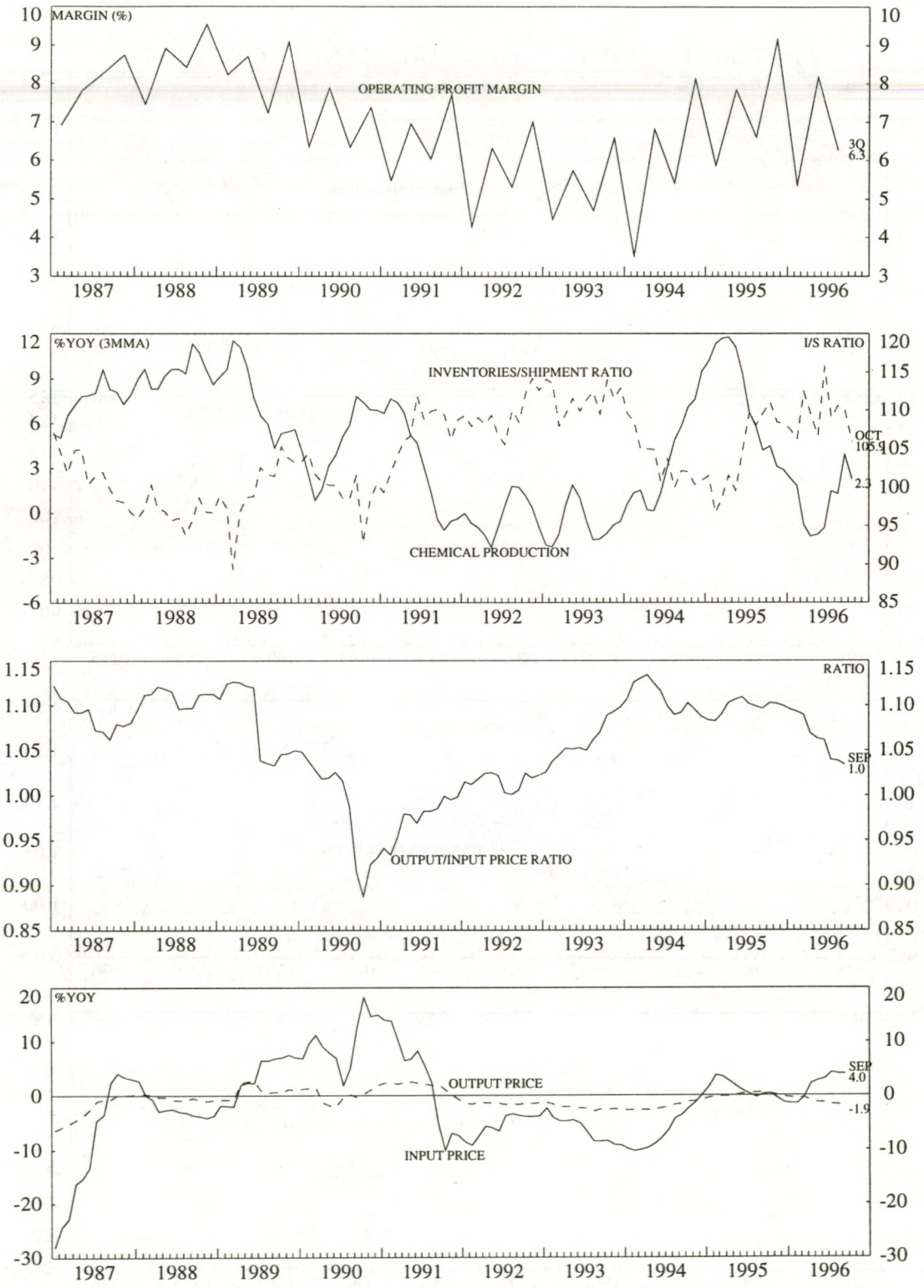


SUMMARY AND CONCLUSIONS: Recurring profit margins have already recovered to above historical average, while gross profit margins are at a historical high. The recovery in corporate profits looks set to slow down as support from falling interest rates wane and the pace of economic recovery slows down. Gross Profit Margins are caught between rising imported input costs (partly due to yen weakness) on the one hand and generally sluggish domestic demand conditions on the other. Further deregulation measures will increase competitive pressures, which will improve efficiency and long term economic growth prospects, but will also put profit margins under pressure. Changes in profit margins look set to vary significantly between sectors, depending on the pricing power and managerial adaptability of companies within each sector. Overall we suspect these structural changes will, at least in the near term, result in more losers than winners among Japan's corporates. Careful sector and stock selection will therefore continue to be a critical factor for success when investing in Japanese equities.

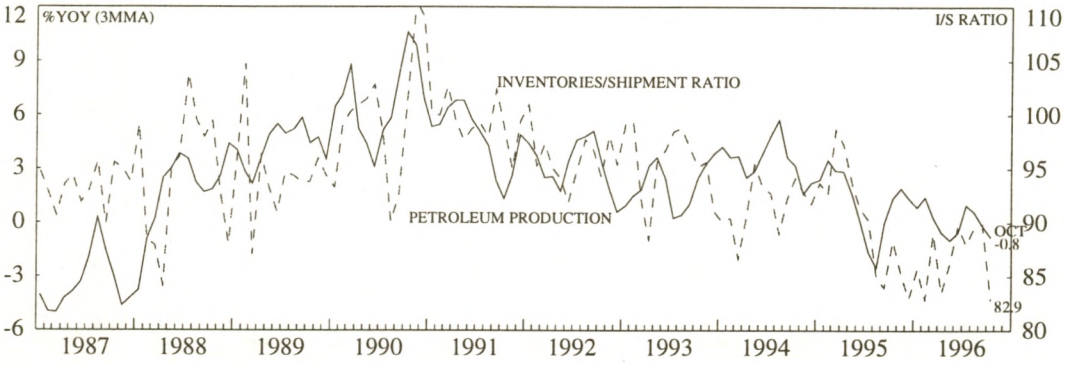
APPENDIX: Profitability and Pricing Power by Sector

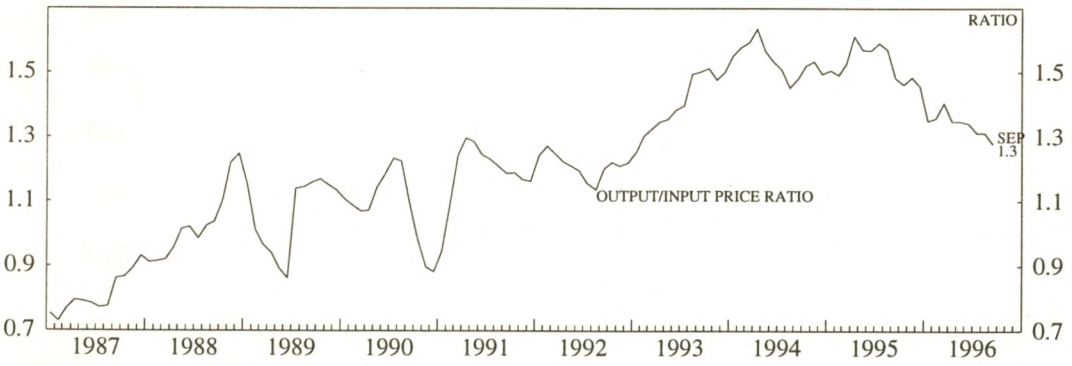


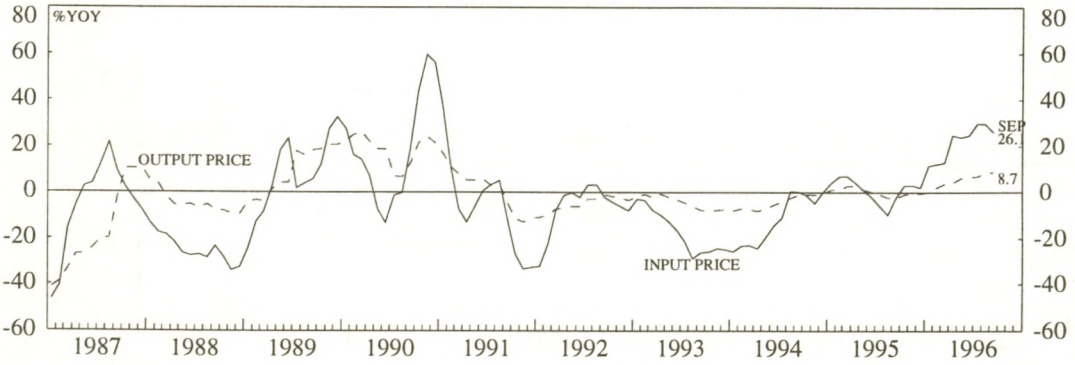
SECTORAL ANALYSIS: CHEMICAL



SECTORAL ANALYSIS: PETROLEUM AND COAL PRODUCTS







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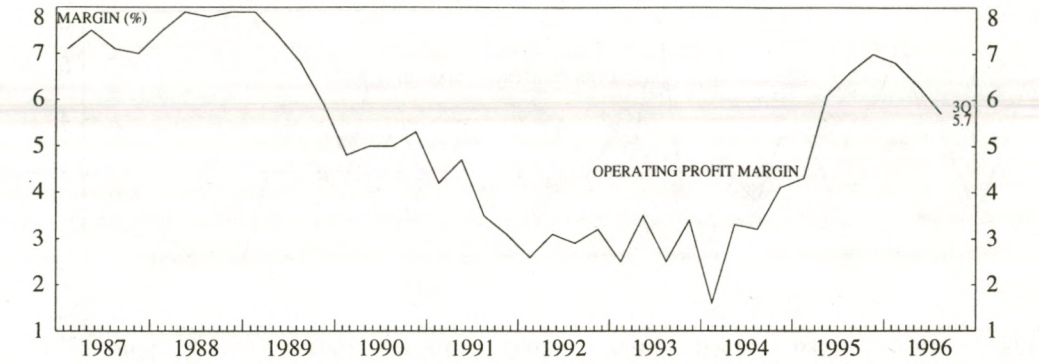
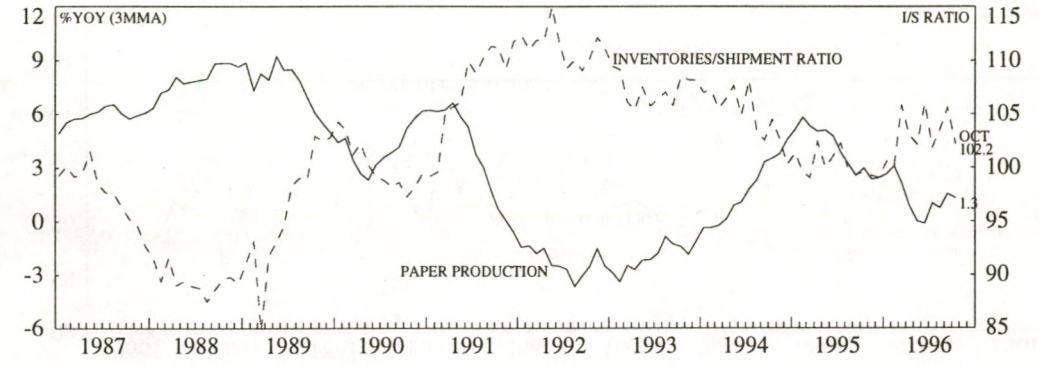
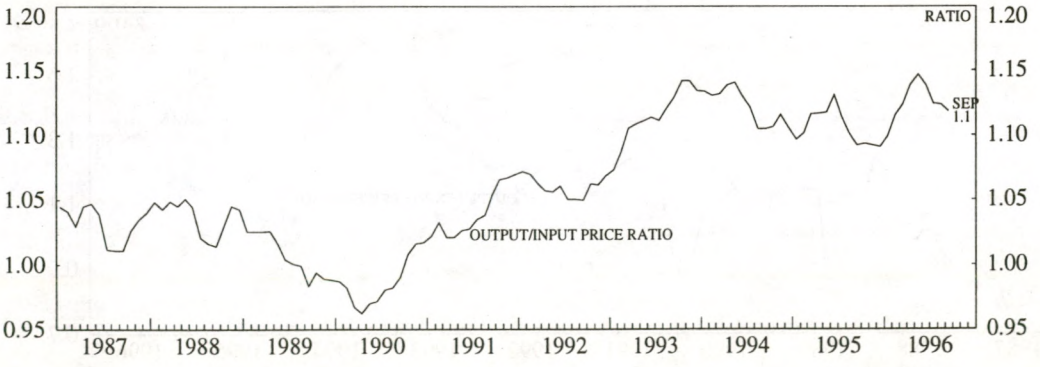
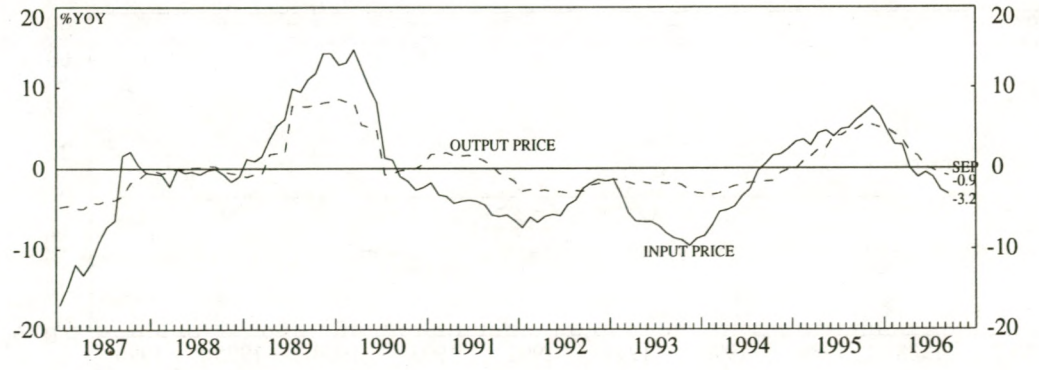
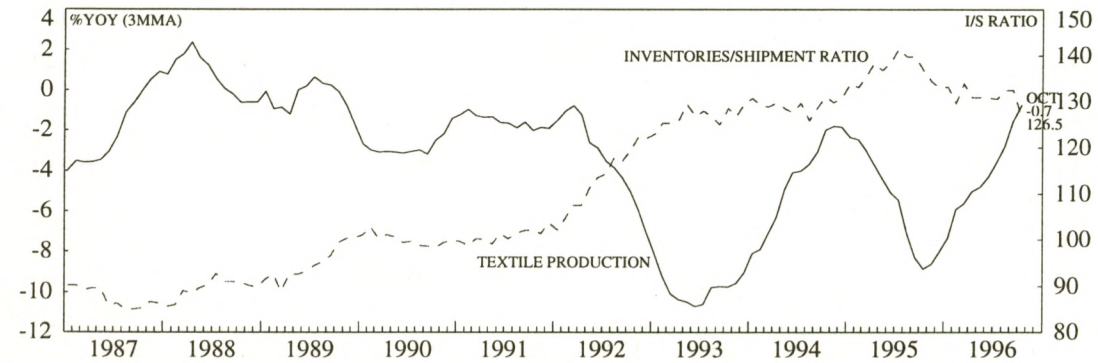


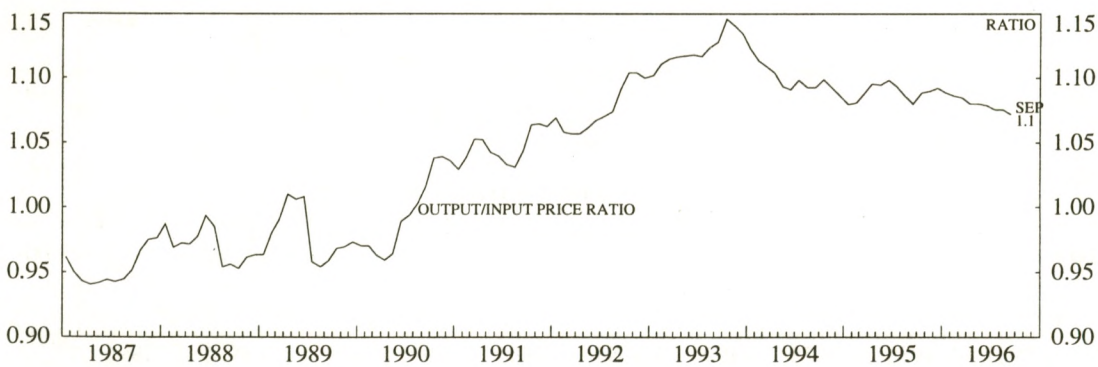


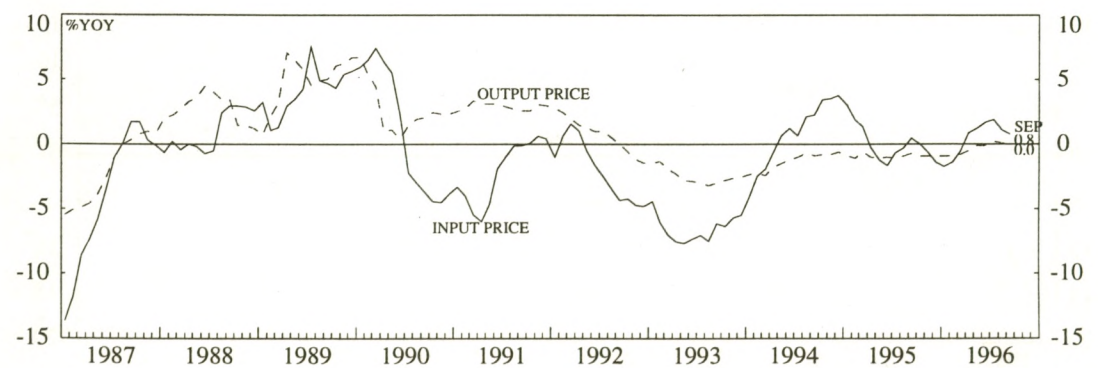




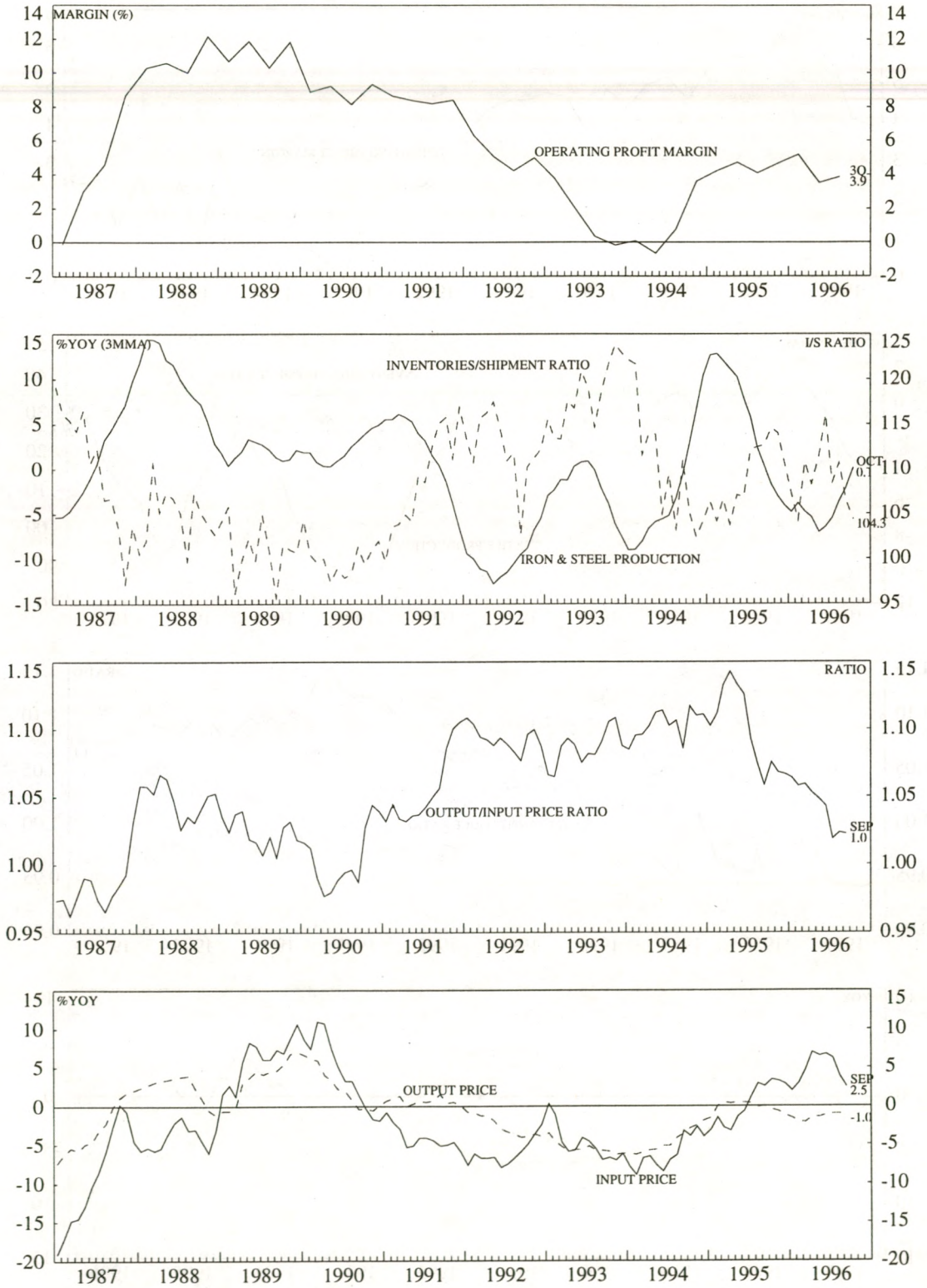
SECTORAL ANALYSIS: TEXTILES



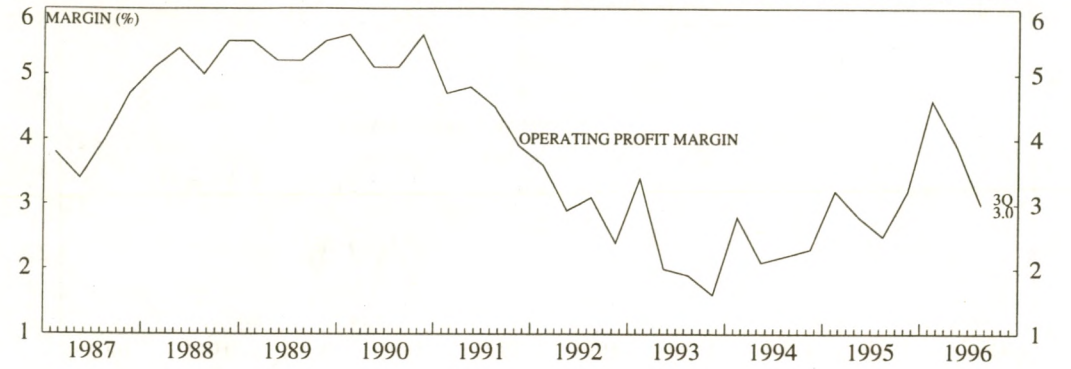


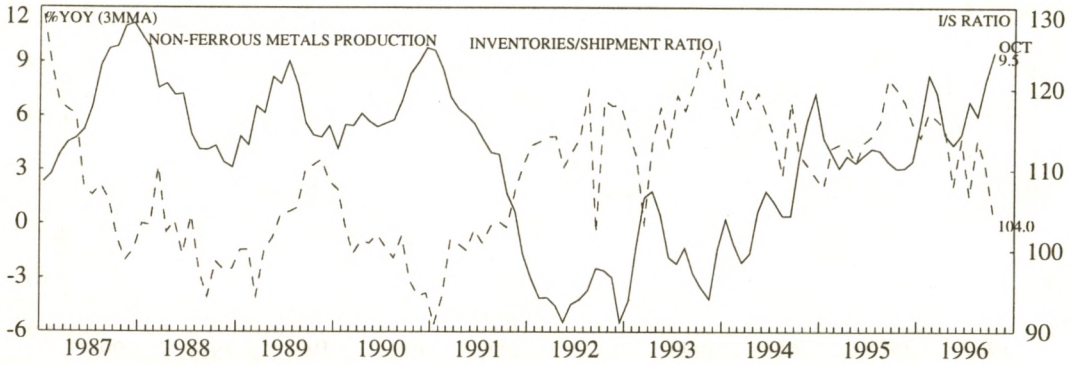


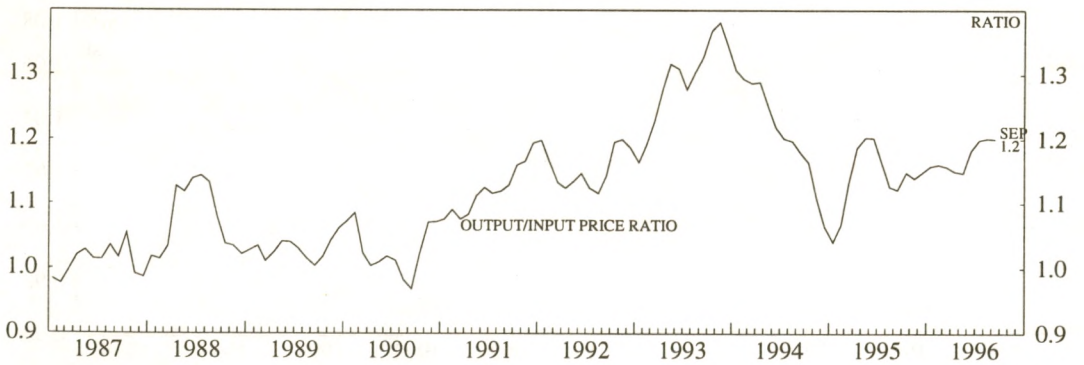
SECTORAL ANALYSIS: IRON AND STEEL

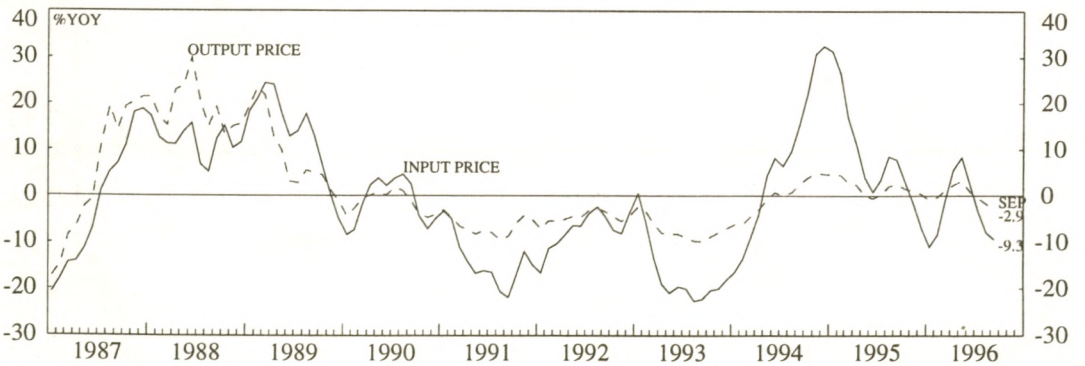


SECTORAL ANALYSIS: NON-FERROUS METALS AND PRODUCTS

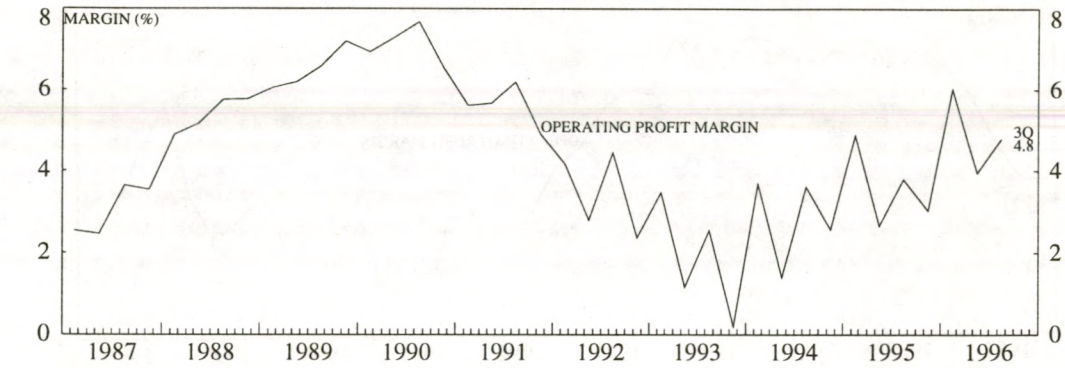


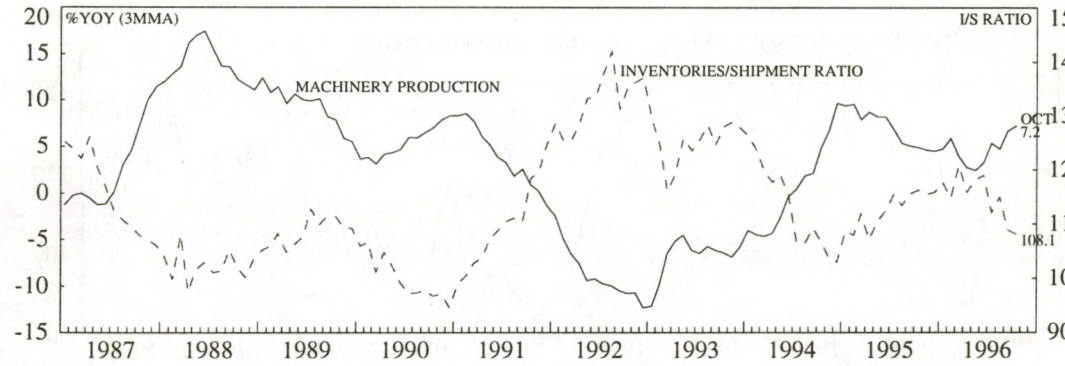


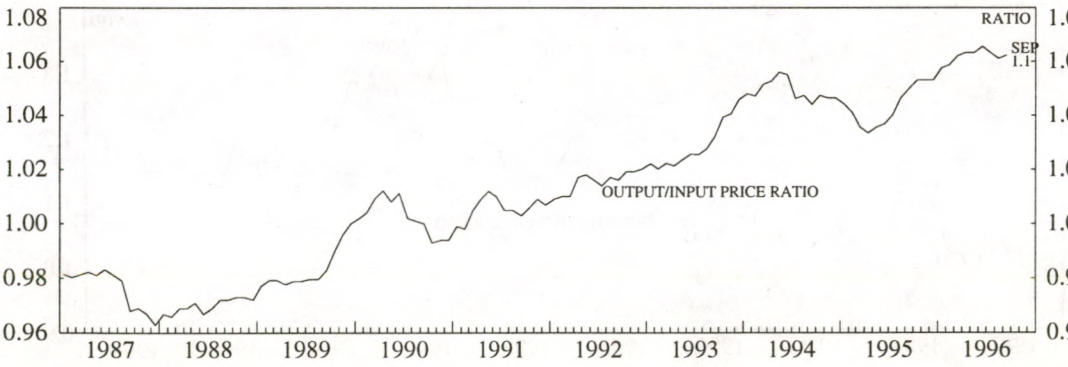


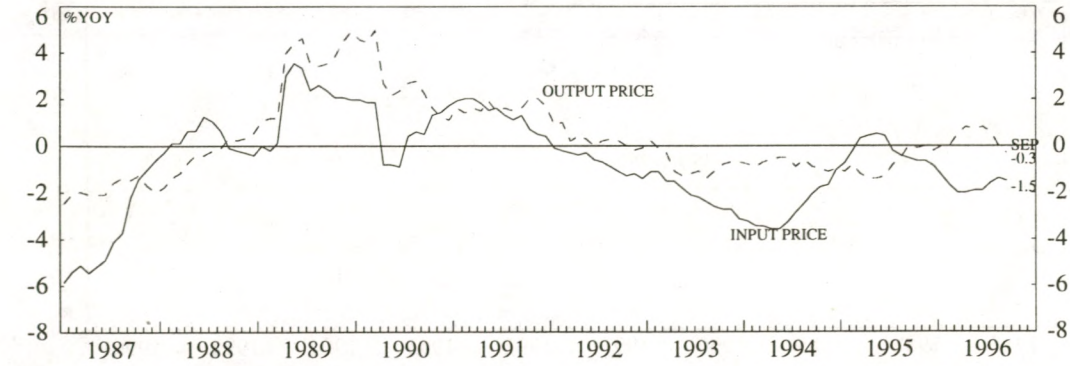


SECTORAL ANALYSIS: GENERAL MACHINERY

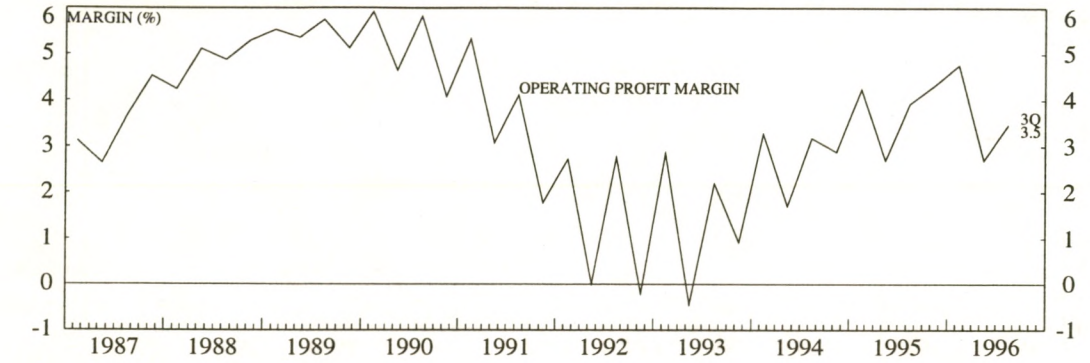


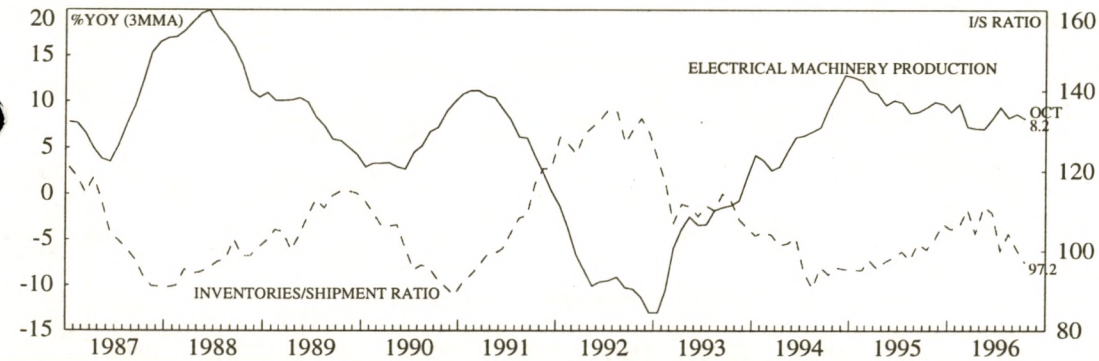


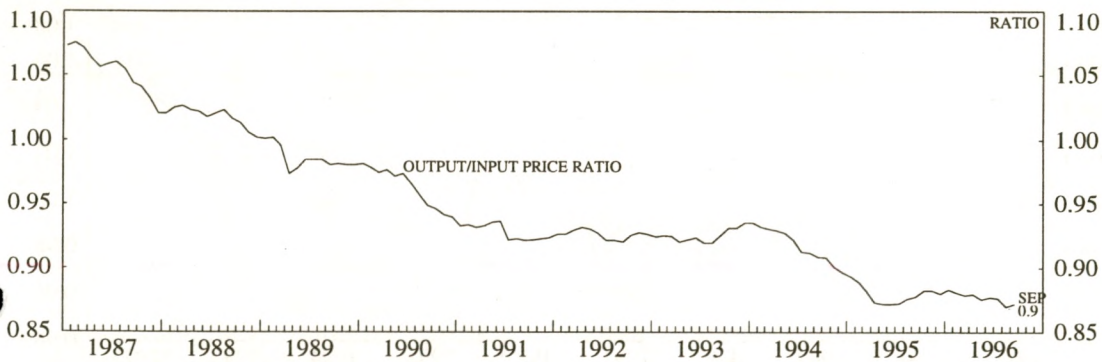


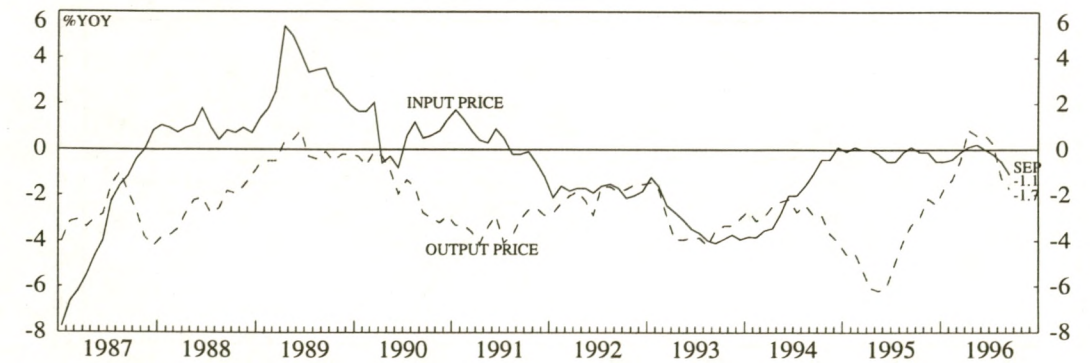


SECTORAL ANALYSIS: ELECTRICAL MACHINERY

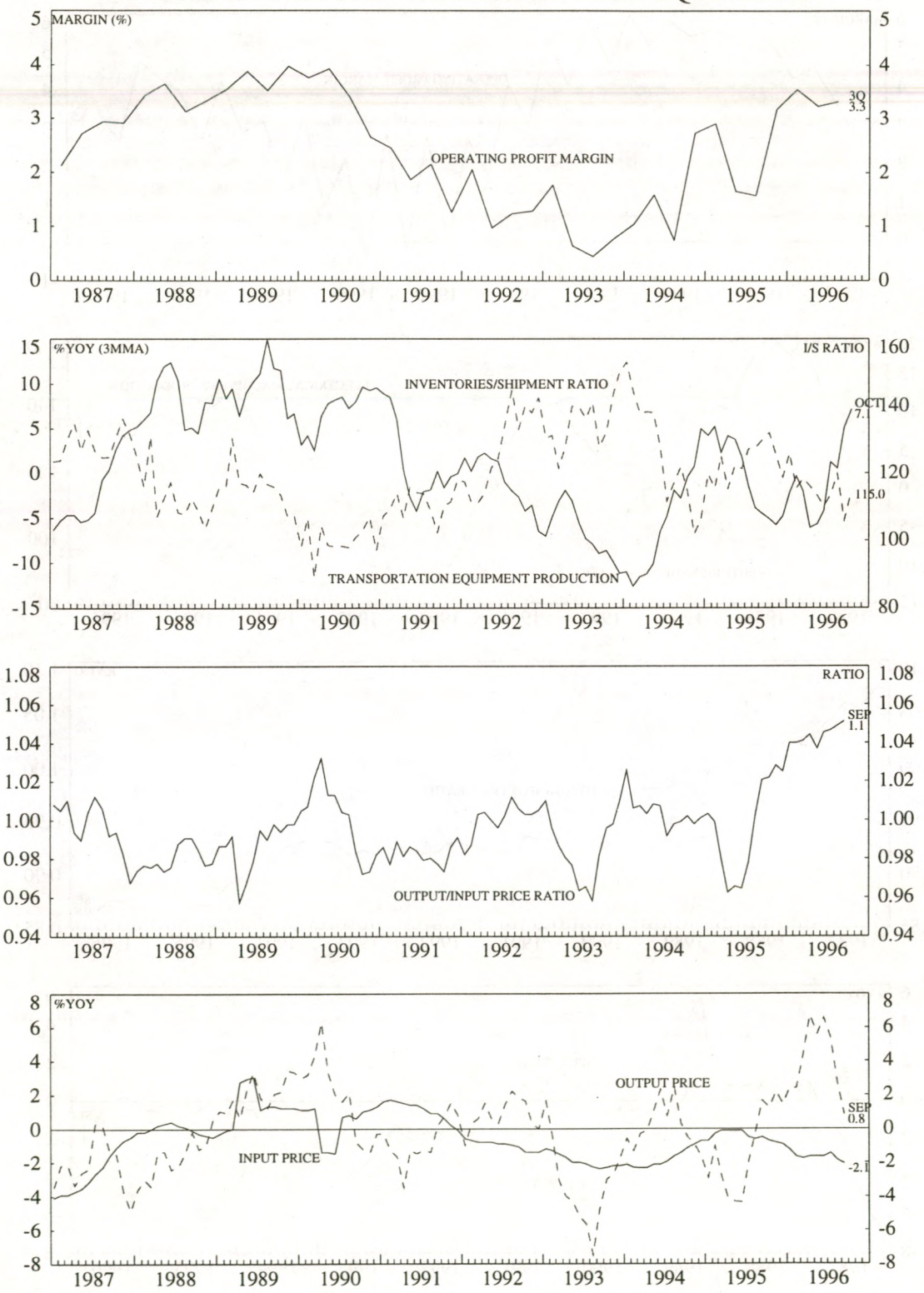




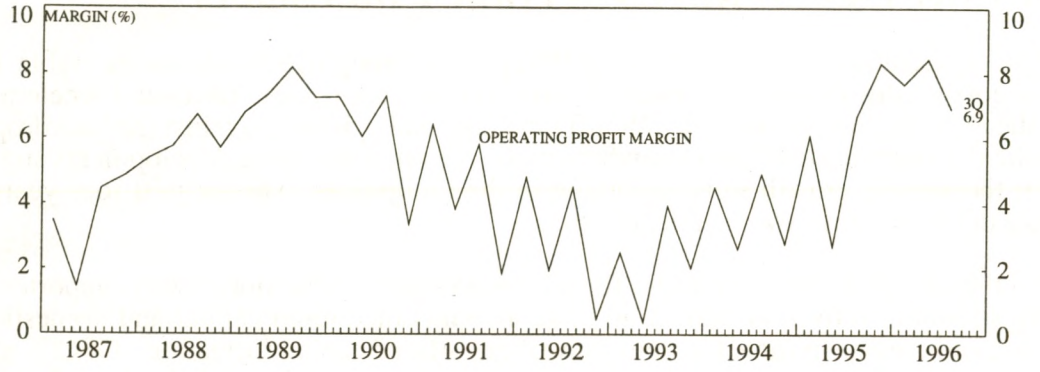


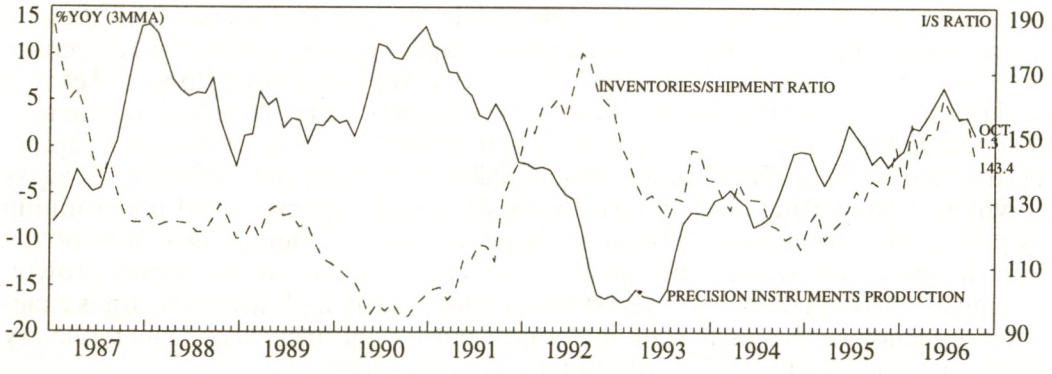


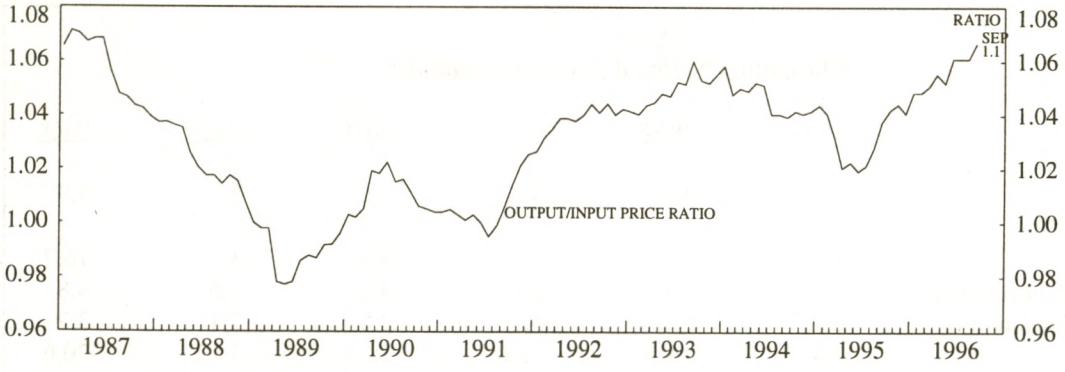
SECTORAL ANALYSIS: TRANSPORTATION EQUIPMENT

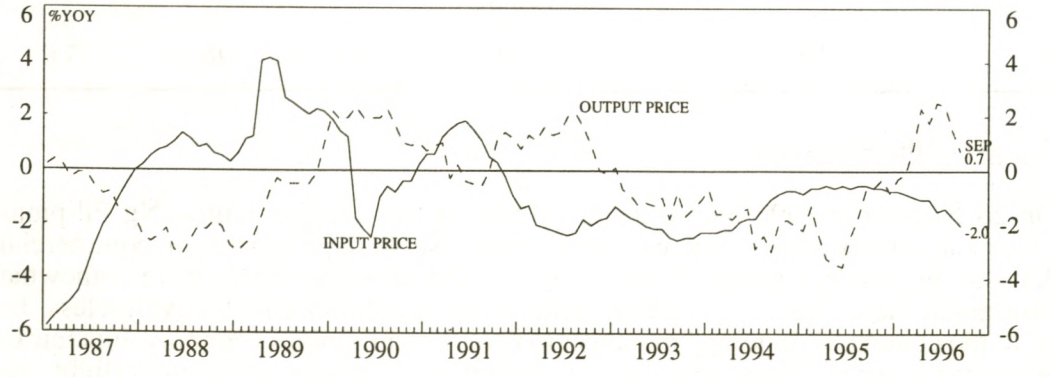


SECTORAL ANALYSIS: PRECISION INSTRUMENTS/MACHINERY









PHILIPPINES
MONETARY EASING REVEALS POLICY DILEMMAS

The acceleration of real GDP in the Philippines through 1996, shown in Table 1 below, is noteworthy in two key respects. Firstly, it comes alongside a substantial deceleration in the average rate of domestic CPI inflation. Secondly, it is set against the backdrop of a cyclical economic slowdown elsewhere in the region. Both these developments suggest that the secular growth story unfolding in the Philippines over the past four years remains a dominant force over cyclical factors.

On the face of it, the secular case for further economic expansion is well supported. Ongoing structural reform is attracting large amounts of foreign capital and domestic private sector investment (note the buoyancy of gross fixed capital formation - GFCF - in the table below), while the economy is endowed with cheap and plentiful supplies of well educated labour. However, we suggest in this article that the Philippines may now be encountering something akin to the "winner's curse" experienced by other ASEAN economies over the past few years: the familiar problem of dealing with capital flows and excess liquidity. The article argues that recent cuts in reserve requirements are understandable in the context of attempts to monetise the economy and diminish reliance on overseas capital. However, the challenge currently facing policy makers is to stem the build up of excess liquidity which is supporting already torrid rates of credit expansion and undermining monetary policy. The problems arise because the central bank is attempting to accumulate reserves and keep the peso stable while, at the same time, sterilising money supply growth. The balancing act has kept domestic interest rates unnecessarily high which in turn is exacerbating the tendency for banks to seek lower cost borrowing overseas. Thus monetary policy caution is called for in 1997 as inflationary pressures intensify.

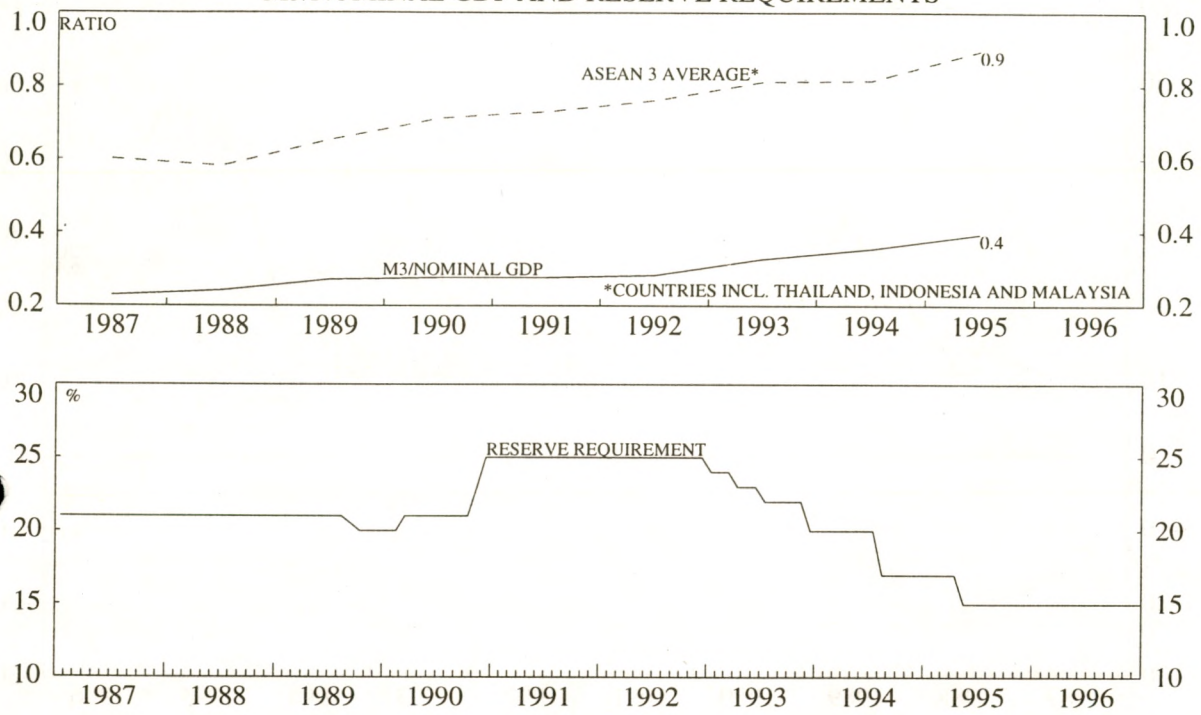
Table 1
Philippines National Accounts Summary

% yoy	1993	1994	1995	96Q1	96Q2	96Q3
GDP	2.1	4.4	4.8	4.6	5.8	5.9
GFCF	12	4.3	4.7	9.7	14.3	16.7
Private Consumption	3.0	3.7	3.8	4.2	4.6	4.8
Govt. Consumption	6.1	6.1	5.4	2.0	2.1	3.7
Exports	7.4	16.5	15.0	28.5	21.2	20.6
Imports	7.1	14.5	16.6	21.0	18.5	20.9
CPI (Ave)	*7.6*	*9.0*	*8.1*	*11.4*	*10.7*	*7.0*

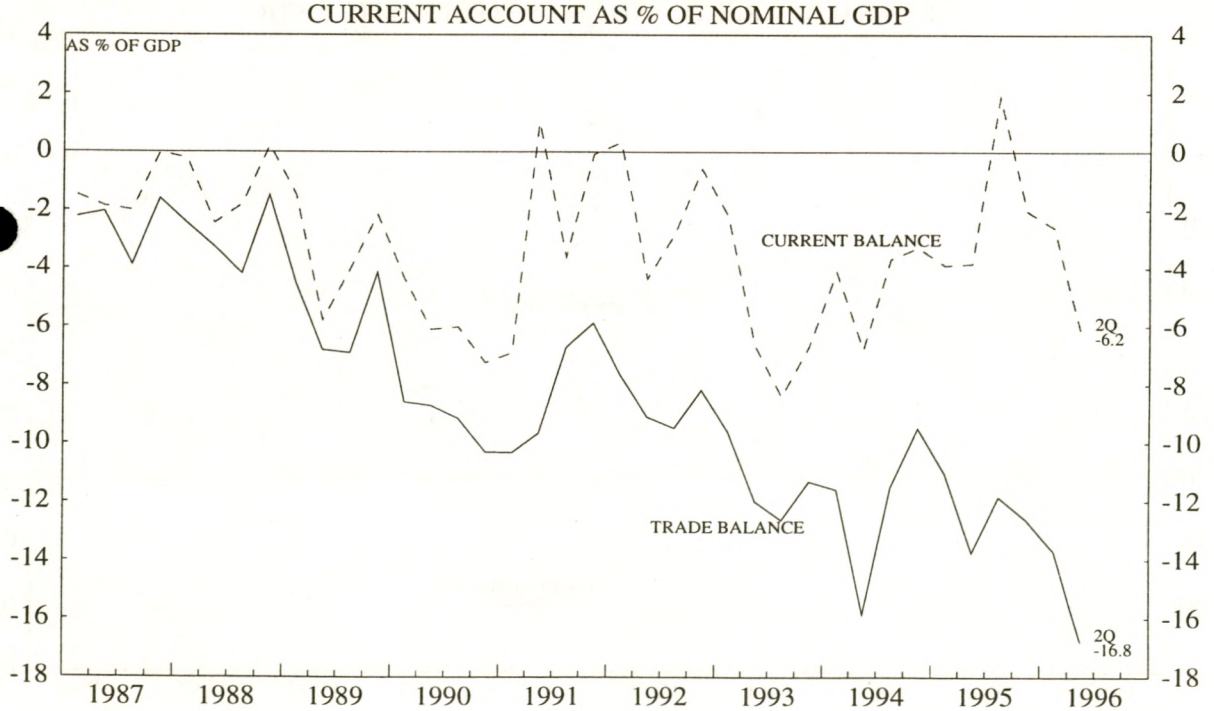
Monetisation of the Economy

On 28 November 1996, the Monetary Board of the Bangko Sentral Ng Pilipinas (BSP), the central bank approved a resolution to cut reserve requirements on commercial bank deposits by two percentage points to 13%. The announcements were somewhat surprising given the apparent strength of domestic demand, but could, nevertheless, be justified in the context of ongoing "monetisation" of the Philippines economy. It is fair to say that after years of political turmoil, economic mismanagement, and capital flight, the economy may well be lacking sufficient financial resources to fuel the current recovery.

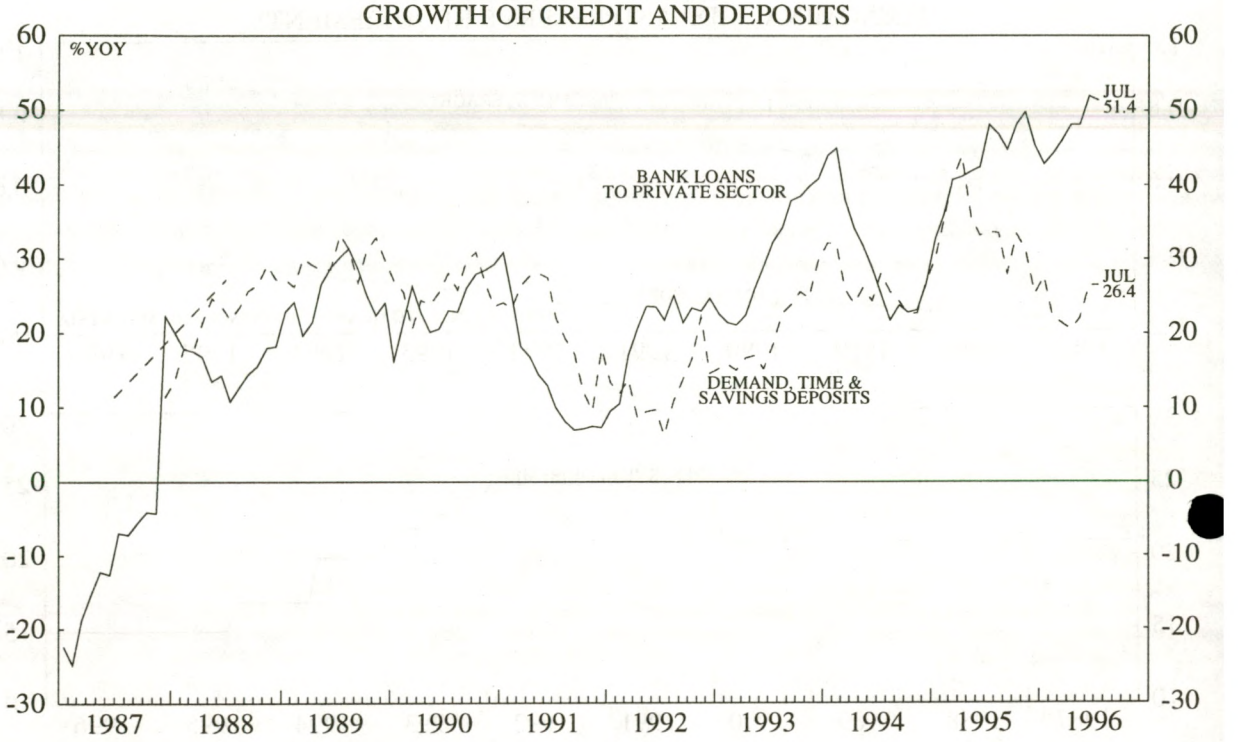
THE PHILIPPINES: CHART 1
M3/NOMINAL GDP AND RESERVE REQUIREMENTS



THE PHILIPPINES: CHART 2
CURRENT ACCOUNT AS % OF NOMINAL GDP



THE PHILIPPINES: CHART 3
GROWTH OF CREDIT AND DEPOSITS



THE PHILIPPINES: CHART 4
GROWTH OF CREDIT AND LOAN TO DEPOSITS RATIO

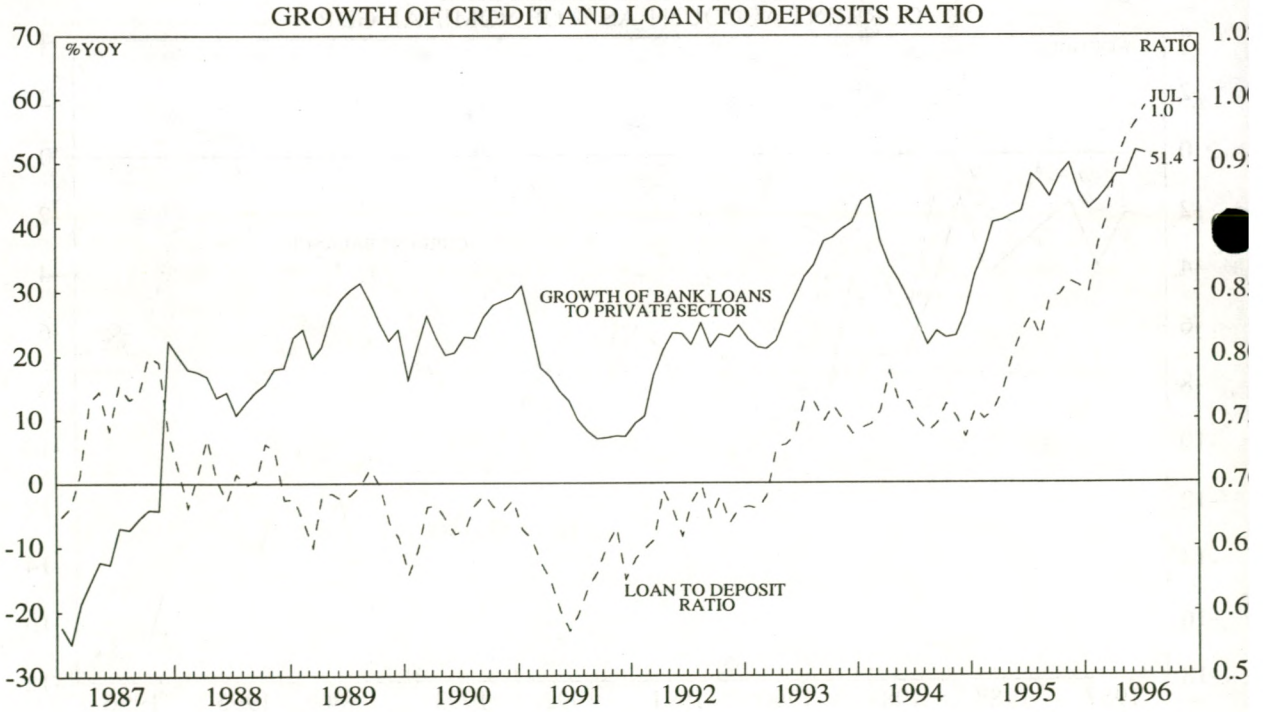


Chart 1 confirms that Philippines is lagging its ASEAN partners in terms of financial depth -- measured here by the ratio of M3 to nominal GDP. Nevertheless, the cycle of reserve of requirement cuts which began in 1993 is beginning to encourage financial intermediation by reducing banks' interest rate spreads. Recovery of the M3/GDP ratio since 1993 reflects that rapid rate of increase in M3 in 1994-95. If the ratio remains high then this will reflect an increase in the demand for money. If not, then there will be further inflationary pressures to come.

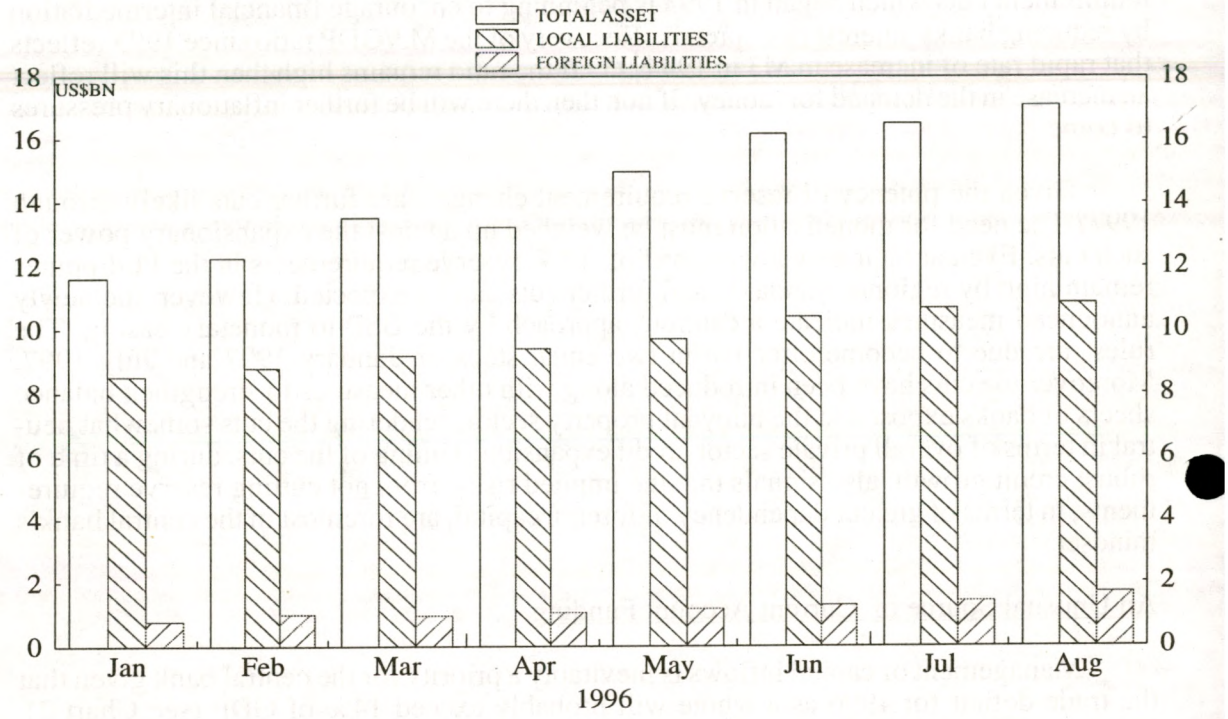
Given the potency of reserve requirement changes, are further cuts likely through 1997? The need for monetisation must be weighed up against the expansionary power of such cuts. Even at their new lower level of 13%, reserve requirements in the Philippines remain high by regional standards and further cuts can be expected. However, the newly announced measures indicate a cautious approach by the BSP to monetary easing. The rules are due to become effective in two equal steps, in January 1997 and July 1997. Moreover the cuts have been introduced along with other measures to strengthen balance sheets of banks exposed to the buoyant property sector; rendering the cuts somewhat neutral in terms of overall private sector credit expansion. Timing of the cuts, during a time of robust credit growth, also signals that the implied risks from not cutting reserve requirements, in terms of greater dependency of foreign capital, are foremost in the central bank's mindset.

An Unusual Source of Current Account Funding

Management of capital inflows is inevitably a priority for the central bank given that the trade deficit for 1996 as a whole will probably exceed 14% of GDP (see Chart 2). Moreover, there is a strong causal link which runs from the acceleration in private sector credit growth shown in Chart 3 to the burgeoning trade gap. However, it is the deviation of credit growth from deposit growth shown in the chart and the resultant explosion in the loans to deposit ratio shown in Chart 4 which is more significant from a balance of payments perspective. In a purely accounting sense, the funding gaps shown in Charts 3 and 4, and the trade deficit, both mirror the expanding savings -- investment gap which must be filled by importation of foreign capital. In the Philippines, however, current account support over the past few years has come from unusual quarters: large remittances by non residents and overseas contract workers (see Table 2).

The rapid growth in overseas worker remittances cannot be relied upon as a stable source of long-term current account funding. Low per capita GDP and a high dependency ratio (defined by the ratio of non working population to the working population) provide powerful incentives for workers to migrate and remit income to the Philippines. This tendency will decline over time as economic growth and wealth provide greater opportunities for workers within the Philippines. Notwithstanding sizeable worker remittances, at present the greater concern must be for the pace of credit extension and poor domestic deposit mobilisation which is forcing banks to source much more funding from overseas sources. These funds for the most part are short term in nature and can be accessed (unhedged) at much lower cost than the equivalent loan in domestic money markets.

THE PHILIPPINES: CHART 5
FOREIGN CURRENCY DEPOSIT SYSTEM



THE PHILIPPINES: CHART 6
GROWTH OF BROAD MONEY SUPPLY, REAL GDP AND INFLATION

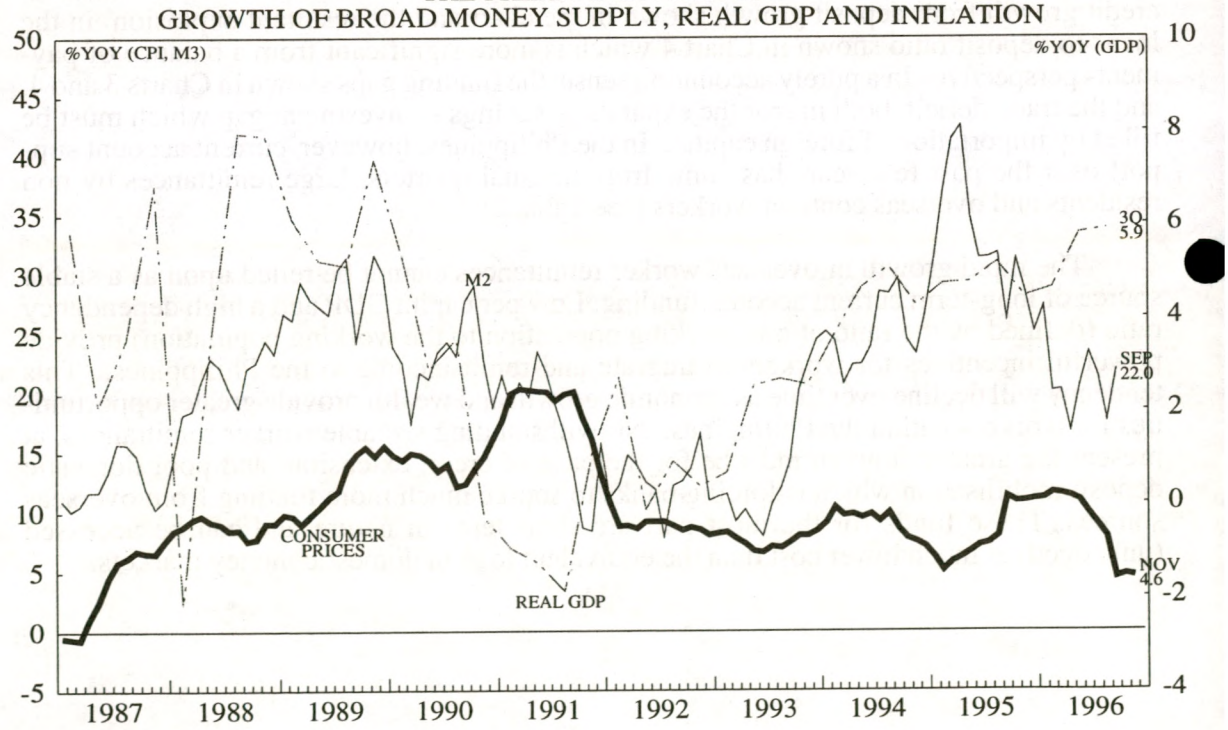


Table 2
Current Account Financing

US$Mn	1992	1993	1994	1995	1996 Jan-Jun
Trade	-4,695	-6,222	-7,850	-8,944	-5,990
Receipt	7,443	7,497	10,550	15,412	10,994
o/w Remittances	2,202	2,229	2,940	4,878	3,471
Others	3,398	3,283	5,591	7,932	5,772
Payments	(4,423)	(4,990)	(6,586)	(9,328)	(7,081)
Current Acc. Net	-858	-3,016	-2,950	-1,980	-1,726
Source: BSP					
Savings Rate (% of GDP)	14.9	13.8	14.9	14.7	
Source: Asian Development Bank					

Workers' remittances and the inflow of foreign capital are captured mainly within the growth of offshore banking units in the Philippines, otherwise termed Foreign Currency Deposit Units. Chart 5 shows that total assets of these FCDUs had grown by almost 47% between January and August 1996, mostly on account of worker remittances which are classified as local resident holdings for the purpose of these statistics. As an aside, it is clear from the deviation of credit and deposit aggregates described above that money supply definitions such as M3, which currently exclude any foreign currency components, are gradually becoming less accurate as measures of private sector purchasing power. At present M3 (broad money) is defined as currency in circulation, current accounts, peso time and savings deposits, plus deposit substitutes (including promissory notes, commercial paper, and repo deposits). If the M3 aggregate were to be augmented by including resident non-bank holdings of foreign currency deposits and CDs then there would be less scope for a divergence between this measure and bank credit.

Excess Liquidity Threatens Inflation Outlook

The analysis so far suggests that recent reserve requirement cuts are likely to have been motivated by an urgent need for financial deepening, the lack of which is increasing banks' dependency on foreign currency finance. In a nutshell, credit growth may be 'too strong' with respect to the low savings rate (see Table 2). In the following paragraphs we will show that although BSP sterilisation of capital flows during 1996 may be restraining M3 growth, banks continue to be able to extend credit more rapidly. This is partly a lagged response to the reserve requirement cuts in recent years. More importantly, the effectiveness of the sterilisation is being reduced as the general level of interest rates is being kept above market-clearing levels.

Sterilisation Dampens Money Growth

Given the pace of private sector credit growth in 1996 it is worth considering whether monetary conditions have been accommodative. On the face of it, recent trends in money supply growth shown in Chart 6 suggest the opposite, although these merit careful interpretation.The relationship between money supply and inflation is easily discernible from Chart 6. Typically, monetary upswings are followed some twelve to eighteen months later by accelerating inflation. It is also fair to say that money demand appears to rise alongside real income growth -- hence the coincident relationship between money supply and real GDP. With these dynamics in mind, the sharp deceleration of M3 growth in 1996

despite the continued acceleration of real GDP appears unusual. A considerable portion of the deceleration in M3 growth is coming off a high base in 1995. However, the extent of deceleration belies the substantial foreign currency inflows, highlighted above, which should have boosted money supply growth. This suggests that the BSP has been intervening vigorously throughout 1996 to prevent appreciation of the peso, while sterilising the impact of such interventions on the money supply.

The summary BSP balance sheet in Table 3 confirms this point. Outstanding BSP debt instruments more than quadrupled between June 1995 and June 1996, rising by P64bn. Meanwhile, international reserves rose by roughly P73bn over the same period. BSP debt instruments at end-June 1996 accounted for roughly 11% of the outstanding M3 stock.

Table 3
BSP Balance Sheet Highlights

Peso bn	1995				1996	
	Q1	Q2	Q3	Q4	Q1	Q2
Total Assets	481	459	493	502	555	575
o/w International Reserves	171	188	206	200	223	261
Domestic Securities	200	160	181	202	229	214
Currency Issue	102	102	102	131	115	113
Deposits (Banks and Government)	251	230	255	244	250	268
BSP Debt Instruments	23	20	29	23	82	84

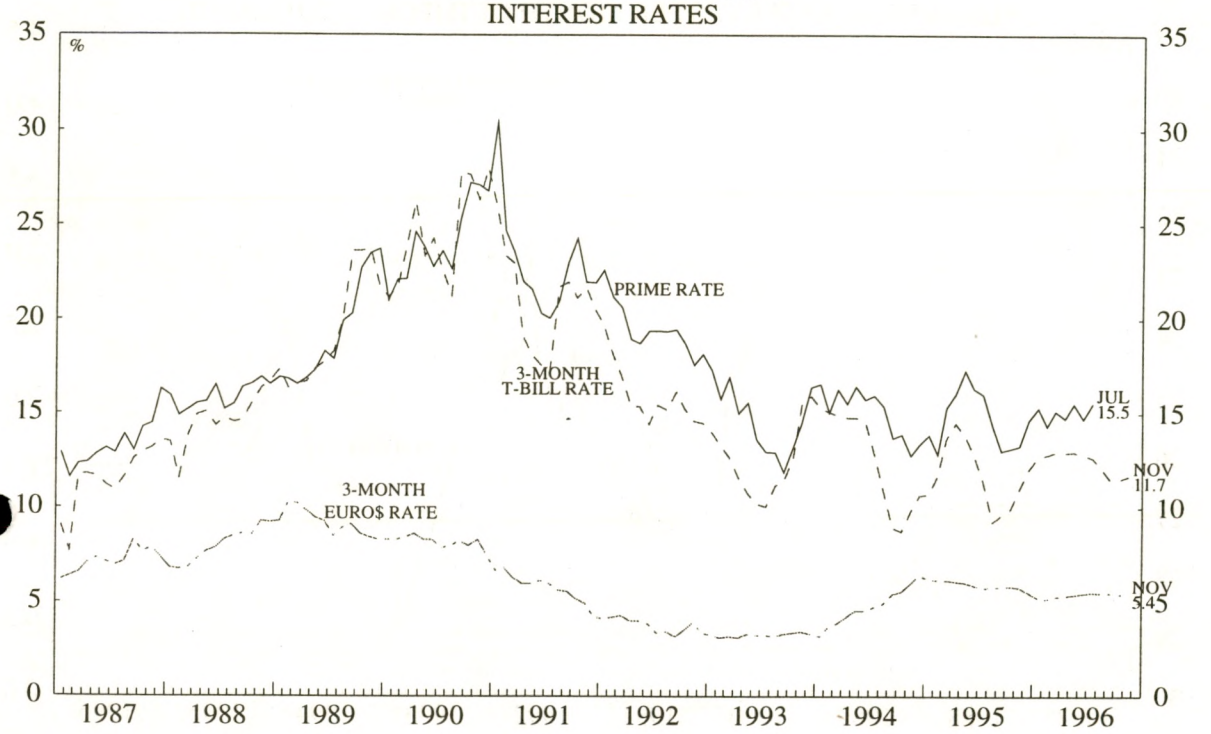
While sterilisation has depressed money supply growth, it has done little to curb loan expansion. At the same time, the overall liquidity position of banks' balance sheets has risen because of the recent cuts in reserve requirements. These buoyant liquidity conditions are likely to be the key deterrent to further substantial monetary easing in the future although it is unlikely that the BSP will be able to prevent interest rates from being dragged lower by the money markets. Most sterilisation is conducted through short-term repo agreements which tend to mature every three months with accrued interest. As a general principle, the BSP is now attempting to extend the maturity profile of such repo operations to reduce their impact on short-term liqudity and interest rates.

Distorted Rates Undermine Monetary Policy

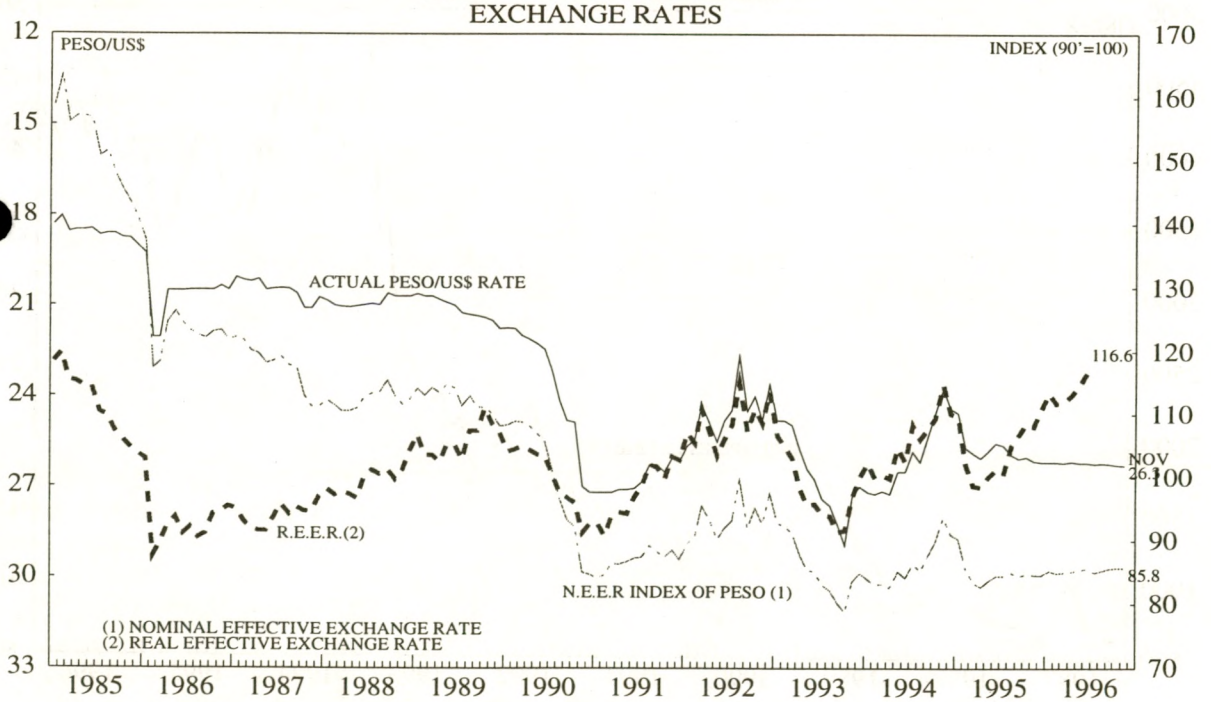
As is to be expected, distortion of the interest rate and exchange rate structure through sterilisation has kept nominal interest rates at relatively high levels throughout 1996 as shown in Chart 7. Evidently these had little impact on the demand for credit. In any event the growing tendency to borrow offshore is clearly increasing domestic loan growth sensitivity to overseas interest rates at the margin (see chart 7 for an indication of the Peso-Eurodollar rate differential). Thus, sterilisation has maintained domestic peso interest rates somewhat 'artificially' high, exacerbating the tendency to borrow more cheaply from overseas but, more importantly, tending to give stability to the peso/US$ exchange rate.

A stable peso was expedient in 1996, partly to support export growth, but also as a counter-inflationary weapon. Stability and even mild appreciation of the nominal effective exchange rate through 1996 (shown in Chart 8) is a key reason why inflation was able to

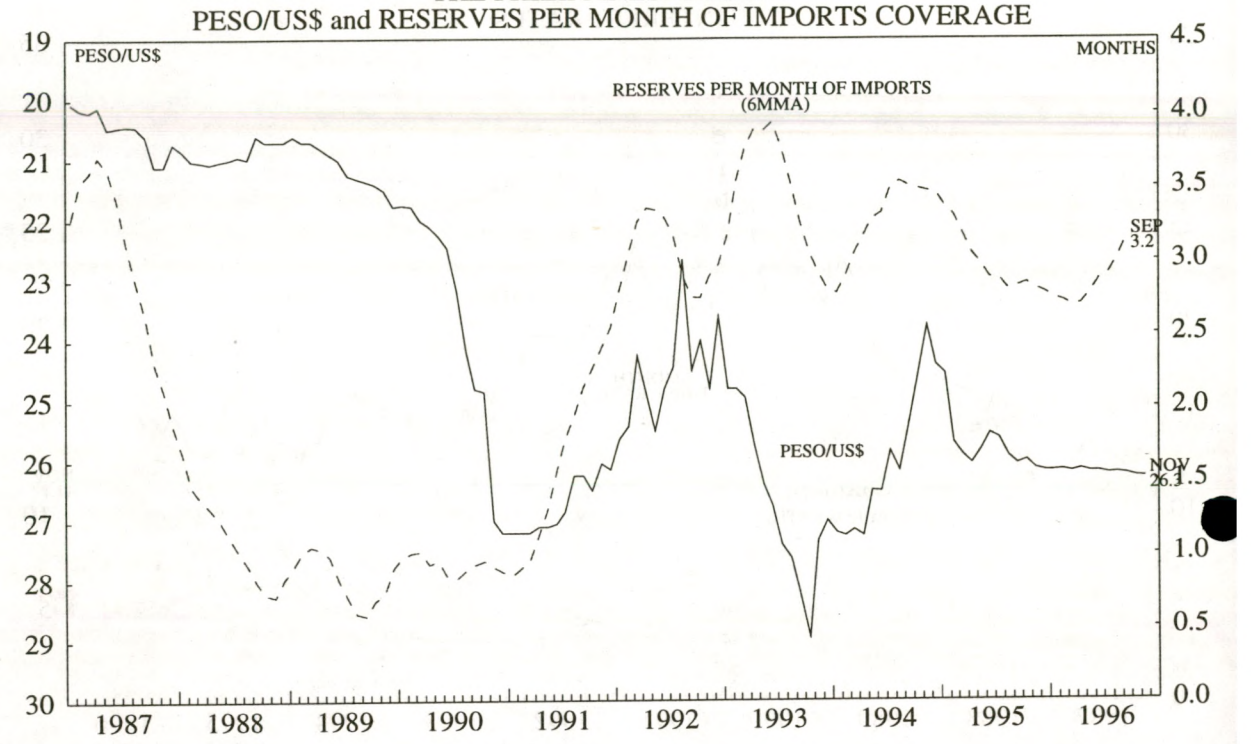
THE PHILIPPINES: CHART 7
INTEREST RATES



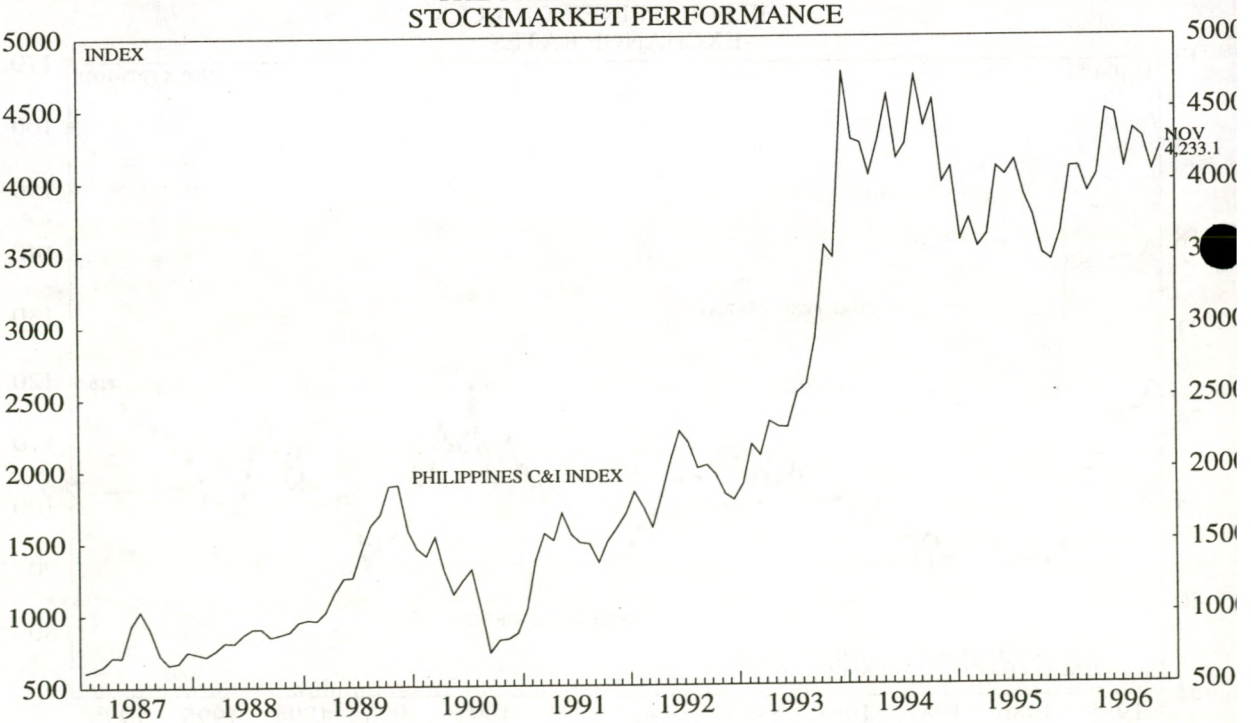
THE PHILIPPINES: CHART 8
EXCHANGE RATES



THE PHILIPPINES: CHART 9
PESO/US$ and RESERVES PER MONTH OF IMPORTS COVERAGE



THE PHILIPPINES: CHART 10
STOCKMARKET PERFORMANCE



decelerate markedly during 1996 H2 from a high base in the previous year (see chart 6 for a review of inflation trends). Policy makers cannot afford to ignore altogether the extent of real effective exchange rate appreciation over 1996 although, as suggested earlier, this is probably acceptable as a temporary consequence of, inter-alia, greater 'openess' and structural reform -- a primary symptom of the "winner's curse". However, looking ahead, it is essential for policy credibility that (1) foreign currency reserves start to accumulate more quickly and (2) the BSP allows the nominal exchange rate to reflect more accurately fundamental trade and liquidity trends. The latter requires the BSP to stop sterilising capital inflows, which would, in turn, allow interest rates to move to market clearing levels. Our analysis so far implies that excess liquidity is exerting downward pressure on domestic interest rates which also implies a lower peso in the short-term. Chart 9 shows that the peso has been allowed to slip marginally over 1995 and 1996, as the US dollar has strengthened, while reserve accumulation has also gathered momentum. Nevertheless, the emergence of excess liquidity is now the main (albeit ineffective) constraint to monetary easing which, if allowed to persist, will have to be dealt with through more severe monetary tightening later in the current upswing -- as the inflationary consequences become more obvious. In the final analysis, it is unlikely that the BSP will be able to sterilise indefinitely and thus keep inflation at bay. While extending the maturities of the repo instruments may temporarily supress money growth, excess liquidity is bound to keep credit growth robust for some considerable time.

Financial Assets Benefit From Liquidity Growth

The Philippines Stock Exchange Index (see Chart 10) enjoyed a rally through late 1995 and early 1996 but succumbed afterwards to dwindling sentiment associated with the regional slowdown in export activity. Liquidity growth, buoyant property prices, and secular economic expansion, will continue to provide support for the fully valued stock market although substantial further gains may be difficult to sustain. The emergence of inflationary (and trade account) pressures through 1997 and 1998 -- and subsequent tightening of monetary policies -- will also undermine substantial future gains.

SUMMARY AND CONCLUSIONS: This article has argued that the Philippines is entering a crucial phase in monetary adjustment which began in 1993 with the current cycle of reserve requirement cuts. Both the burgeoning trade deficit, which will exceed 14% of GDP in 1996, and the emerging gap between peso deposit and credit growth are symptoms of low domestic savings and lack of financial depth. These financing gaps are being simultaneously closed through heightened recourse to overseas borrowing and (somewhat fortuitously) inward worker remittances. Further cuts in reserve requirements (albeit in the distant future) can be expected to reduce intermediation costs. In any event the overwhelming tendency will be for lower interest rates, reflecting greater access to cheaper overseas capital. BSP sterilisation of capital inflows has kept interest rates higher than market-clearing levels, partly in support of the peso, as a counter-inflationary measure. One side-effect of these central bank policies has been to lend buoyancy to financial assets including the stockmarket. Strong credit growth has not responded so far to higher interest rates while excess liquidity and financial deregulation is undermining the BSP's ability to rein in credit growth. This implies that inflationary pressure will become more entrenched through late 1997 and 1998 diminishing the attractiveness of financial assets. Meanwhile the secular growth phenomenon unfolding in the Philippines remains intact and prone to deliver more upward earnings surprises for the stockmarket.

TAIWAN
MONETARY CONDITIONS TURN THE CORNER

Introduction

This year, gains in the Taiwanese equity market have led those in Asia -- rising by over 30% in US$ terms. This has been a relatively benign bull run for Taiwanese equities by historic standards because so far, export growth and more generally the balance of payments have contributed relatively little to monetary conditions. Starting in 1996, the authorities have pursued increasingly more stimulative domestic monetary policy with the aim of reviving or at least stabilising the current slowdown in credit growth and the real economy. As will be shown later in the article, this has released more funds for security investments.

Looking ahead, if the external sector picks up through the course of 1997 then there may be no need for the authorities to continue to ease, indeed they may struggle to prevent money market interest rates from declining further. This would present an even more favourable background for the stockmarket and prospects for an upswing in credit growth would brighten more quickly. However, in the meantime a continuation of stagnating credit growth has encouraged an official move to ease monetary policy. This article starts with a brief analysis of the main changes to banks balance sheets over the past 2 years and then moves on to evaluate how the external environment might be expected to impact them in the year ahead.

Main Changes to Commercial Bank's Balance Sheets

Deposit Money Banks (DMBs) assets comprise around 85% of all financial institutions assets in Taiwan. Over the last 2-3 years DMB's balance sheets have undergone 3 main changes. First, their overall growth has slowed down from rates in the mid to high 'teens to single digit growth. The growth of a broad measure of bank deposits such as M2 has slowed from around 20% in 1993 to 8.5% today (chart 1). Both longer term NT$ deposits (time savings deposits) and a collection of shorter term savings and checking deposits (altogether making up around 75% of DMB's total liabilities) have slowed in the last 2-3 years (table 1) -- in line with M2 growth.

A second major change to DMB's balance sheets concerns their net foreign currency position. This year, for the first time since 1990, the net foreign currency asset position on DMB's balance sheets has moved from negative to positive territory. This is because DMB's have accumulated a higher level of foreign assets and experienced a decline in foreign currency funding. This has been another factor contributing to a slowing in NT$ asset growth on DMB balance sheets.

The third major development within DMB balance sheets concerns a change in the composition of banks NT$ assets, as shown in table 1. The rate of growth of loans and discounts -- around 80% of total assets -- has decelerated uninterruptedly from 20% in the year to Sept. 94 to 2% in the year to Sept. 96. Lending to the private sector, which forms the bulk of this, has slowed even further to 0% (year-on-year) today. Loans to government agencies, possibly those involved in infrastructure projects, have become marginally more important. Property related lending forms the largest single element of DMB's loans portfolio and accounts for 40%+ of total loans. This section of lending has slowed in line with the total, with all of its growth accounted for by the rise in property loans to individuals. Meanwhile lending to the commercial property sector has declined for the last 2-3 years.

TABLE 1
MAIN BALANCE SHEET CHANGES OF DEPOSIT MONEY BANKS (DMBS)

Year to:	ASSETS (% Change)				LIABILITIES (% Change)						TOTAL
	Foreign Assets	Total Loans & Discounts	Total Portfolio Investments	Claims on CBC	Foreign Liabilities	Time-Saving Deposits	Other Short Term Deposits	Govt & PSS Re-Deposits	OFI	CBC	
Sept 96	+13%	+2%	+41%	-9%	-18%	+11%	+8%	+2%	+34%	+6%	+7%
Sept 95	+19%	+12%	+16%	+4%	+2.9%	+13%	+10%	+1%	+27%	+21%	+11%
Sept 94	+9%	+20%	-21%	+11%	0	+19%	+11%	+14%	+49%	+53%	+14%
	(4%)	(80%)	(12%)	(6%)	(3%)	(36%)	(38%)	(8%)	(5%)	(3%)	

TABLE 2
MAIN BALANCE SHEET CHANGES OF CENTRAL BANK OF CHINA (CBC)

Year to:	ASSETS (% Change)		LIABILITIES (% Change)			TOTAL
	Foreign Assets	Claims of Financial Institutions	Government Deposits	Statutory Reserve	Redeposits by PSS	
Sept 96	-3%	+6%	-24%	-10%	-10%	-3%
Sept 95	+2%	+21%	+51%	+4.5%	-2%	+1.5%
Sept 94	+5%	+53%	-3%	+12%	+2%	+8%
	(84%)	(14%)	(5%)	(30%)	(30%)	

Notes: 1) All figures expressed as annual percentage changes to September
2) Numbers in brackets denote that particular asset/liability as a percentage of total in 1996
3) Source: Financial Statistics Monthly, CBC
4) Figures rounded off to nearest whole %
5) P.S.S. is Postal Savings System
6) In Table 1, O.F.I is other Financial Institutions

Loans for working capital purposes form most of the rest of bank's portfolio of loans (around 40% of the total). This has been at a virtual standstill for the past 2-3 years.

The decline in the tempo of term lending has been partly offset by rapid growth in bank's holdings of portfolio investments (table 1). At present this element accounts for around 12% of total assets. It is composed of: government bills and bonds, bankers acceptances (BA), negotiable certificate of deposit (NCD), commercial papers (CP) and equities. Of these, holdings of non-financial sector securities, such as commercial paper (CP), now account for around 50% of the total securities held. Chart 2 shows total values of CP, BA and NCDs outstanding. Throughout 1996, one can see that the total stock of CP outstanding (in addition to that sitting on banks balance sheets) has risen, while the issuance of other securities has remained fairly constant. This trend partly reflects the decline in short term interest rates over the last 2 years (chart 3). The domestic banks have typically lowered their prime lending rates with a delay, following a decline in short term money market rates. In the meantime, large creditworthy corporate borrowers are able to switch to securitised forms of borrowing. This is what has happened through 1996.

Main Changes to the Central Bank's Balance Sheet

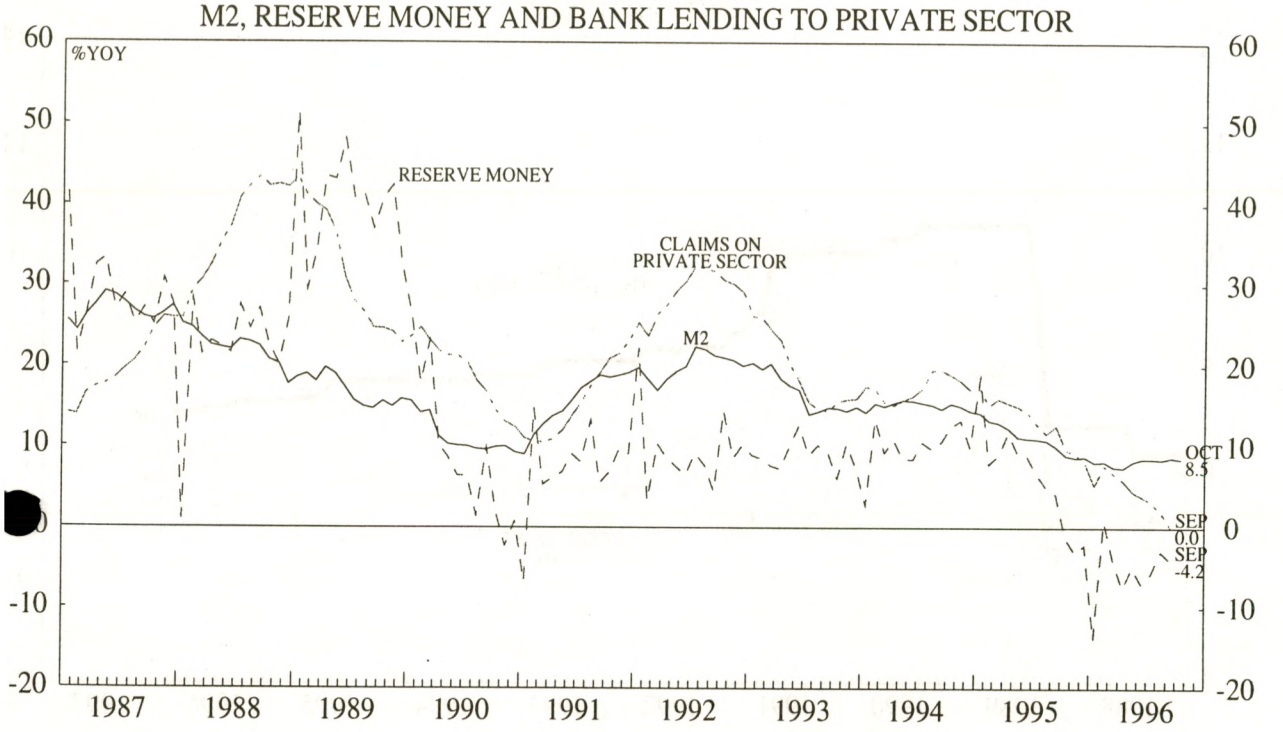
The changes to DMB's balance sheets mentioned earlier (i.e. the decline in M2, bank lending and changes to their net foreign currency positions) have not occurred without some adjustments to monetary policy. In recent years, the monetary policy operations of the central bank -- the Central Bank of China (CBC) -- have focused on two main areas. The first is a continuous reduction in statutory reserve requirements and the second is to ensure a degree of stability in the NT$.

The CBC intervenes in the foreign exchange market at times to stabilise movements in the NT$. This is the main cause of changes to its holdings of foreign exchange reserves. Moreover, changes in official foreign exchange reserves have been the main determinant of changes to the monetary base. As illustrated by charts 4 & 5 and in table 2 the CBC was accumulating a greater stock of foreign exchange reserves through 1993-94. It was buying foreign currencies for NT$ deposits, thereby adding further growth to reserve money. However, this trend went into reverse from mid-1995 to mid-1996 as the CBC stepped in to support the NT$/US$ during times of weakness, such as during the time of the Missiles crisis.

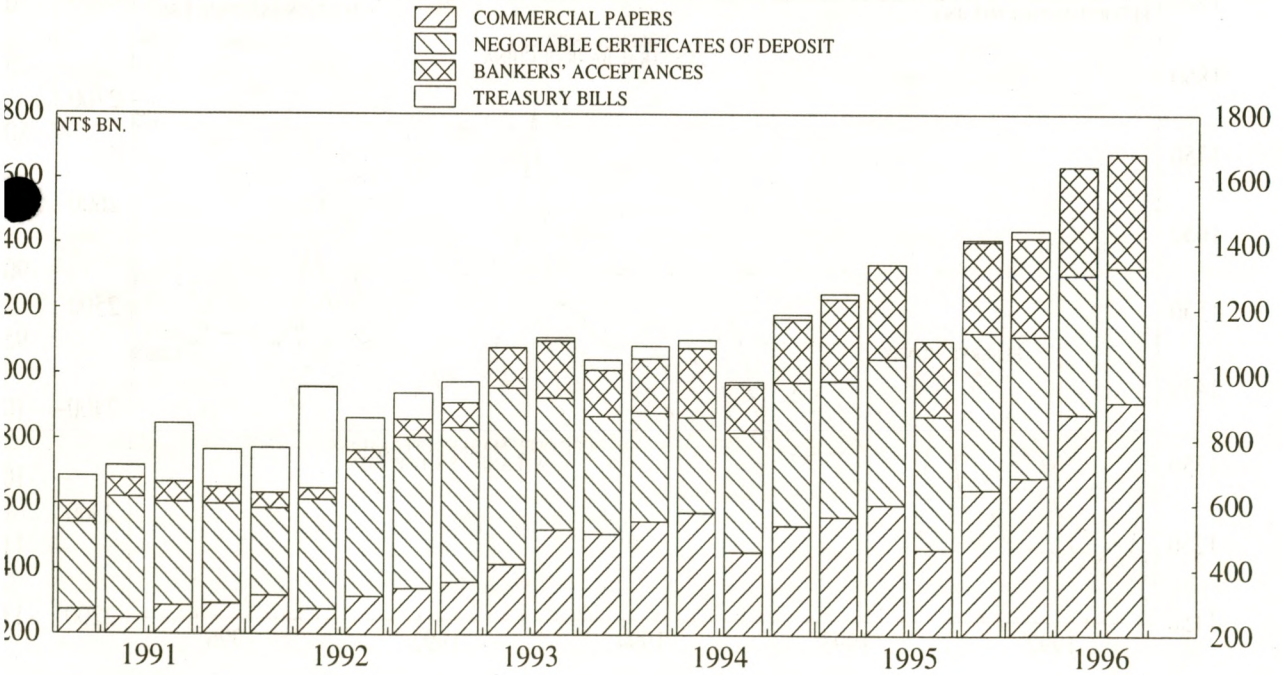
The withdrawal of capital by investors placed downward pressure on the NT$/US$, raising market expectations of a weaker exchange rate. As the CBC intervened to support the NT$/US$ rate it reduced the supply of NT$ deposits and ultimately brought about a decline in M2 growth. This process also encouraged a change in the net foreign currency position at DMBs towards holding more foreign assets and less foreign liabilities, as described earlier.

After the downward pressures on the NT$/US$ had abated -- towards the middle of this year -- the CBC was able to conduct more stimulative domestic monetary operations to try to alleviate the adverse impact of the currency support on M2 growth. To date it has used three main methods. The first is to conduct more open market lending, although in the year to Sept. 96 this has grown by only 6%, much less than in previous years. A second source of monetary easing has occurred as the postal savings system (and to a lesser degree, the government) have run down their deposits at the CBC. Finally the CBC have cut statutory reserve requirements more rapidly in the year to September than in previous years.

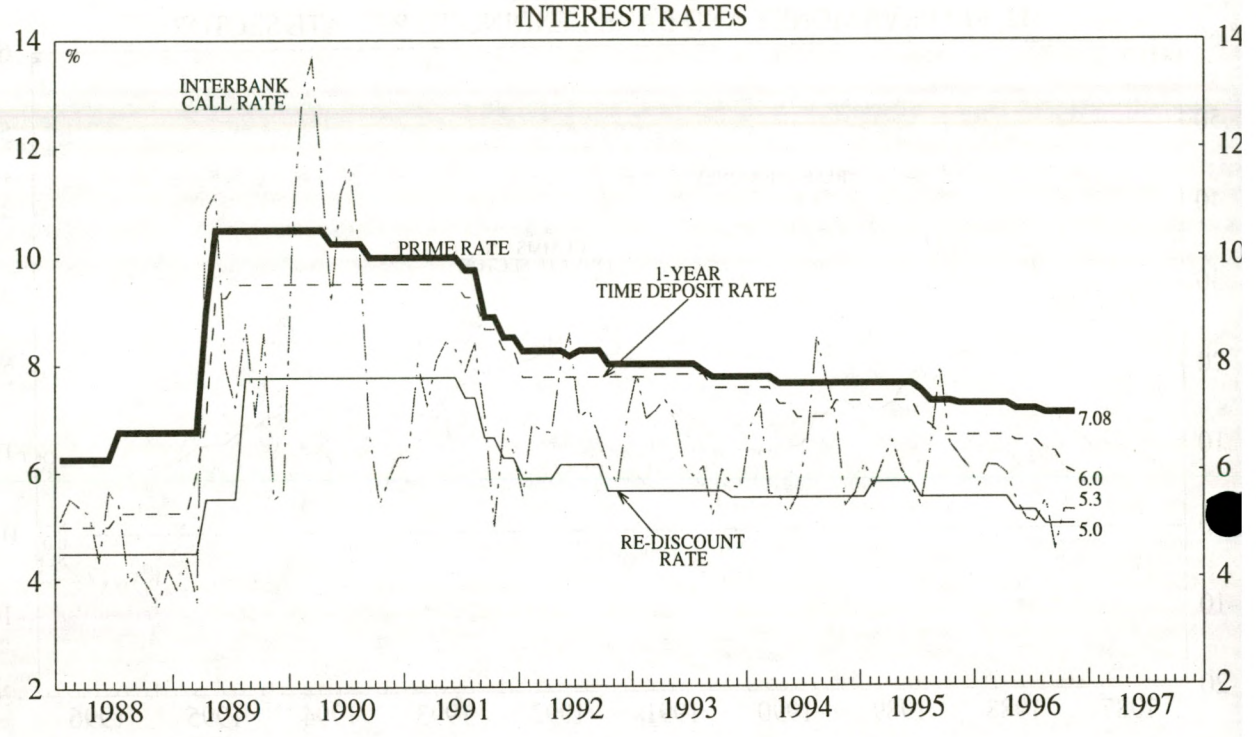
TAIWAN: CHART 1
M2, RESERVE MONEY AND BANK LENDING TO PRIVATE SECTOR



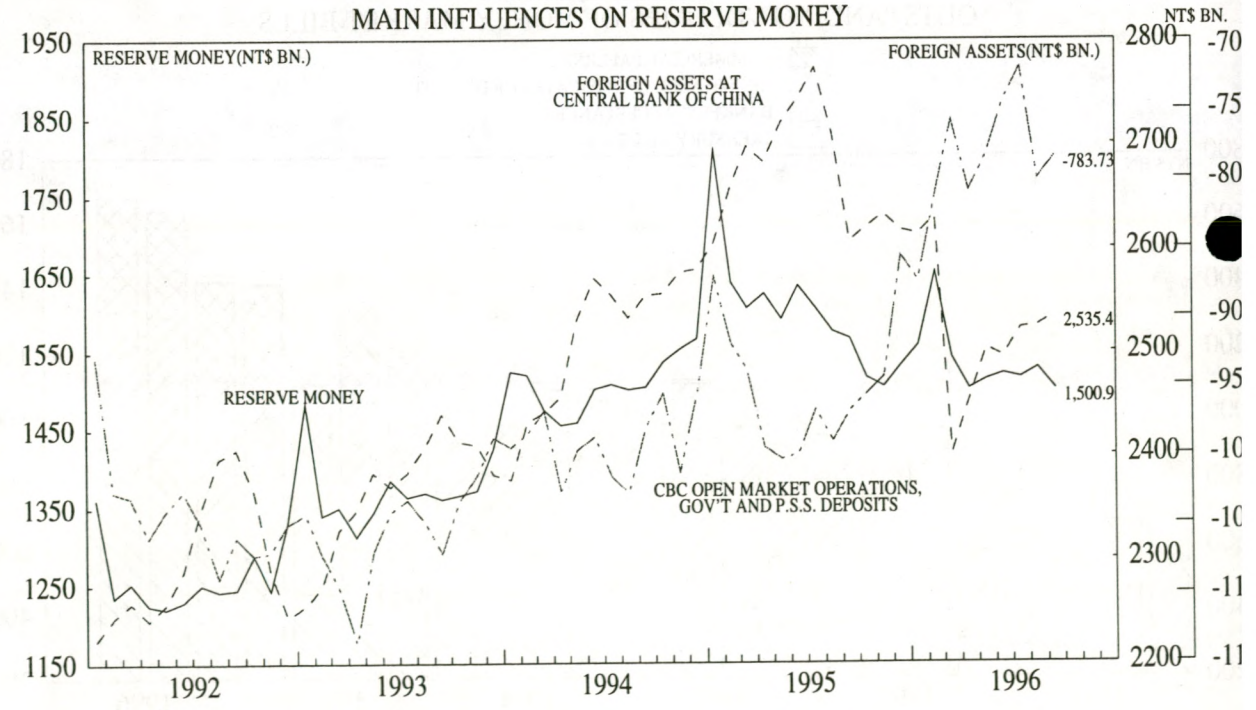
TAIWAN: CHART 2
OUTSTANDING VOLUMES OF MONEY MARKET BILLS



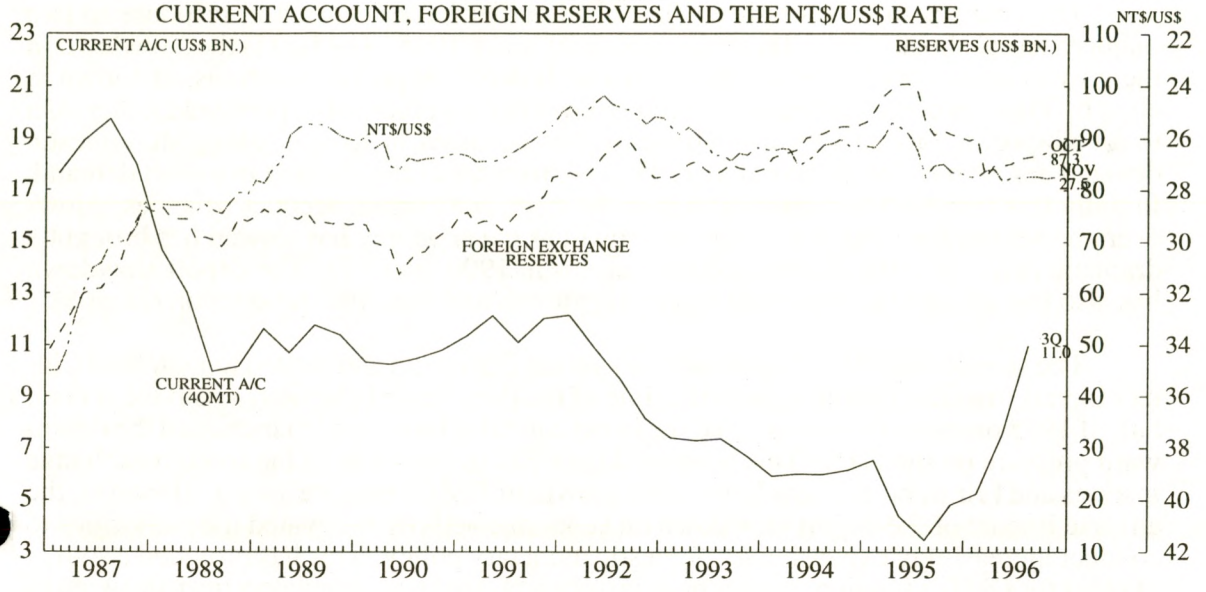
TAIWAN: CHART 3
INTEREST RATES



TAIWAN: CHART 4
MAIN INFLUENCES ON RESERVE MONEY



TAIWAN: CHART 5
CURRENT ACCOUNT, FOREIGN RESERVES AND THE NT$/US$ RATE



The CBC has been reducing reserve requirements gradually since 1989. There are still a number of substantially different reserve ratios applicable to different types of deposit. However, the lowest ratio has been reduced from 11% in 1989 to 6.4% today. This applies to time-savings deposits, the largest homogeneous block of deposits held at DMBs. In total, DMBs hold statutory reserves at the CBC equivalent to approximately 6% of total NT$ deposits, down from 9% in 1991 and 11% in 1989. Over the last 5 years these cuts in statutory reserve requirements have contributed to a rise in the money multiplier (ratio of broad deposits to monetary base). In recent years this has meant that the same stock of M2 can be supported by a smaller level of reserve (or high powered) money. Banks have been able to intermediate funds more efficiently with each reduction. At some stage, this will bring a decline in the spread between bank's cost of funds and their lending rates.

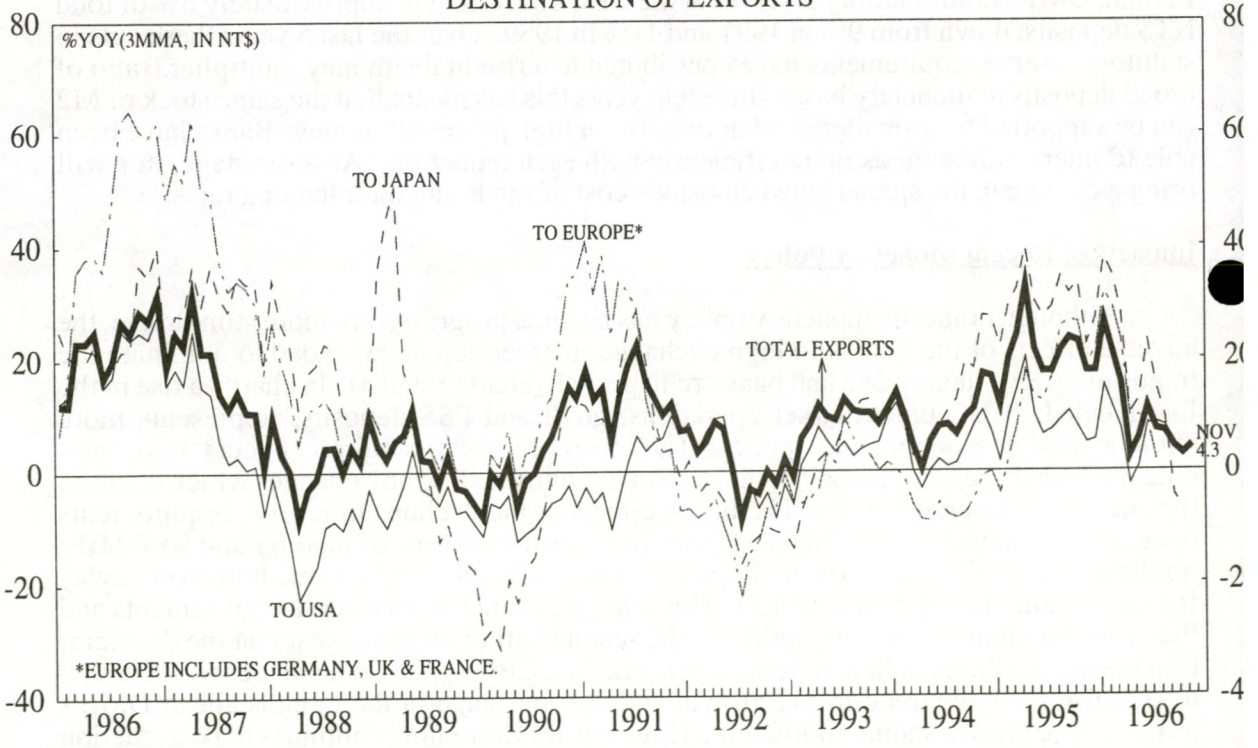
Impacts of Recent Monetary Policy

Although domestic monetary policy has become progressively more stimulative, the adverse effects of the CBC's foreign exchange intervention have tended to dominate the trends in reserve money, M2 and bank credit growth (charts 1 and 4). In chart 4 a rise in the line labeled: 'CBC open market operations, gov't and PSS deposits,' represents more stimulative domestic monetary policy. The series of reserve requirement cuts have lowered the level of reserve money in the system notwithstanding any changes which occur in the sources of reserve money. The initial effects of the declines in reserve requirements have been to stimulate more rapid growth in securitised forms of lending and so DMBs' holdings of securities have risen. In part, this represents a shift by some borrowers away from term lending to securitised debt. However, the reduction in reserve requirements and the more stimulative monetary policy in the second half of 1996 suggest that the deceleration in bank lending could reach a trough soon. The CBC appear to have loosened enough to stabilise the downtrend in M2 growth and at some stage in the months ahead DMB's term lending growth should follow suit. However, this loosening continues to be a reaction to the 1995-96 balance of payments weakness, counteracting it, rather than dominating the direction of monetary policy outright.

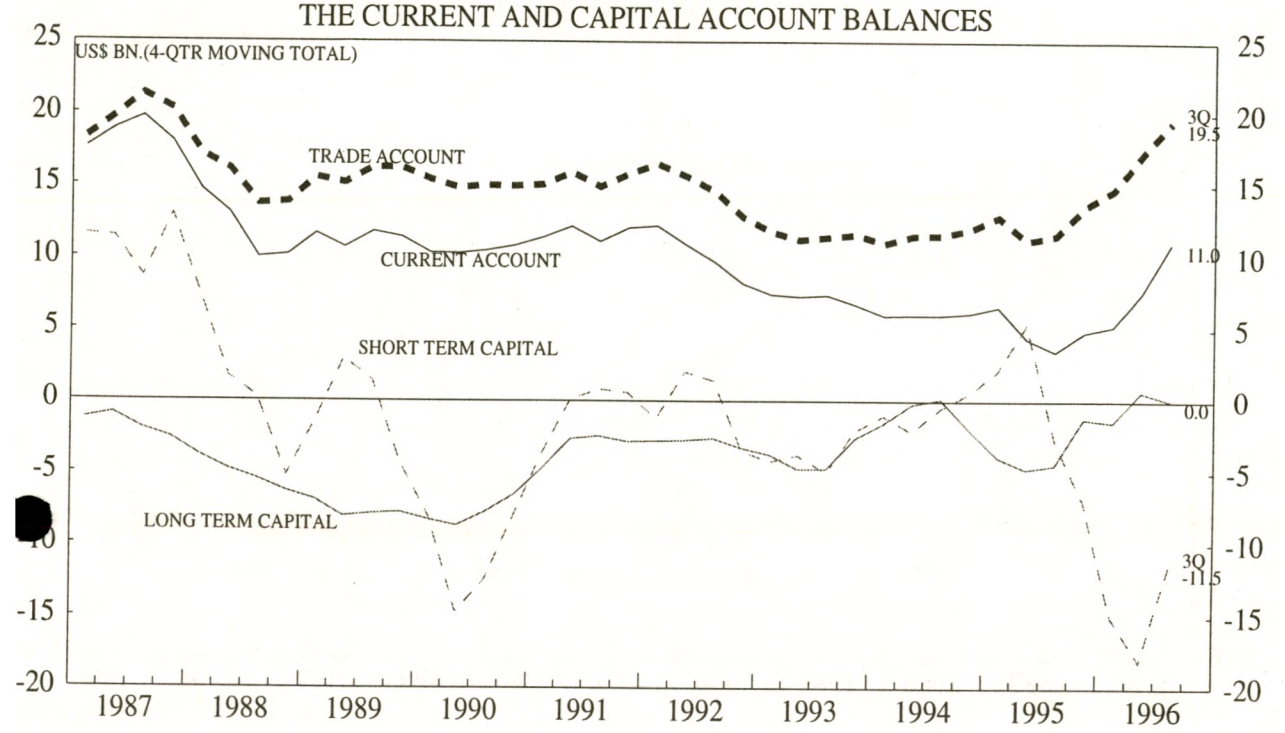
The changes to balance sheets described earlier have occurred in response to two major external shocks to the Taiwanese economy since 1995. The first is the slowdown in the growth of exports in US$ terms to most of Taiwan's export destinations, as shown in chart 6. This has occurred because of a slowdown in the volume of exports sold rather than to a collapse in Taiwan's terms of trade, as has occurred in Korea. Sluggish domestic demand across most of the world in 1995 explains most of this decline in export demand. Initially this trend led to a deterioration in the trade and current account balances. However, the subsequent collapse in import growth as the economy has slowed has brought a dramatic reversal in the current account surplus in 1996 (chart 7). The export slowdown has also had an adverse impact on economic growth and industrial production (chart 8).

The second major external shock was political in origin and related to mainland China's threats towards Taiwan around the time of the Presidential election. From the second half of 1995 onwards there was a decline in net capital inflows, which increased the downward pressure on the NT$. This prompted the CBC to intervene in the foreign exchange markets and bring about a slowdown in the growth of DMB's balance sheets. However, the adverse impact of the export slowdown on economic activity motivated the authorities to conduct increasingly expansionary domestic monetary policy. This has provided a source of relief for DMB's funding, but has been insufficient, so far, to stimulate a fresh upswing in bank credit growth and economic activity. One indicator of the level of transactions demand in the economy is the trend in growth of cash in circulation. As can be seen in chart 9, seasonal effects aside, this moves broadly in line with DMB credit growth and has been on a downtrend for the last 2 years.

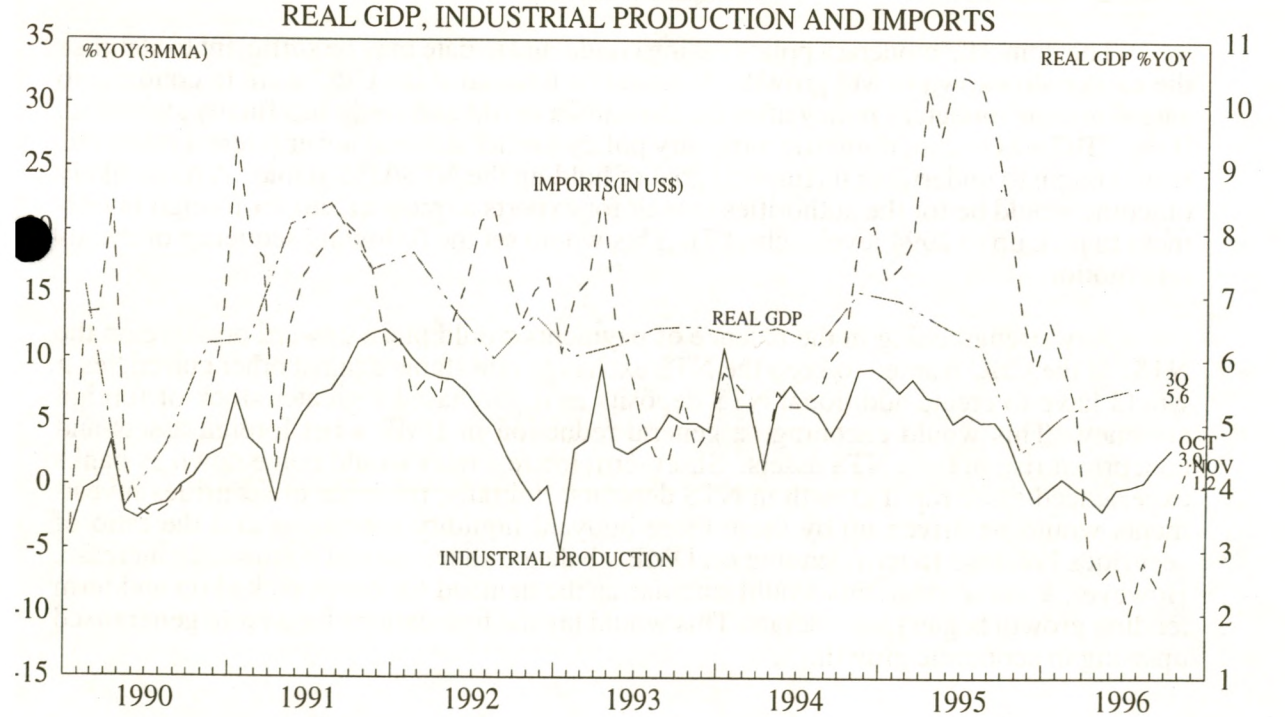
TAIWAN: CHART 6
DESTINATION OF EXPORTS



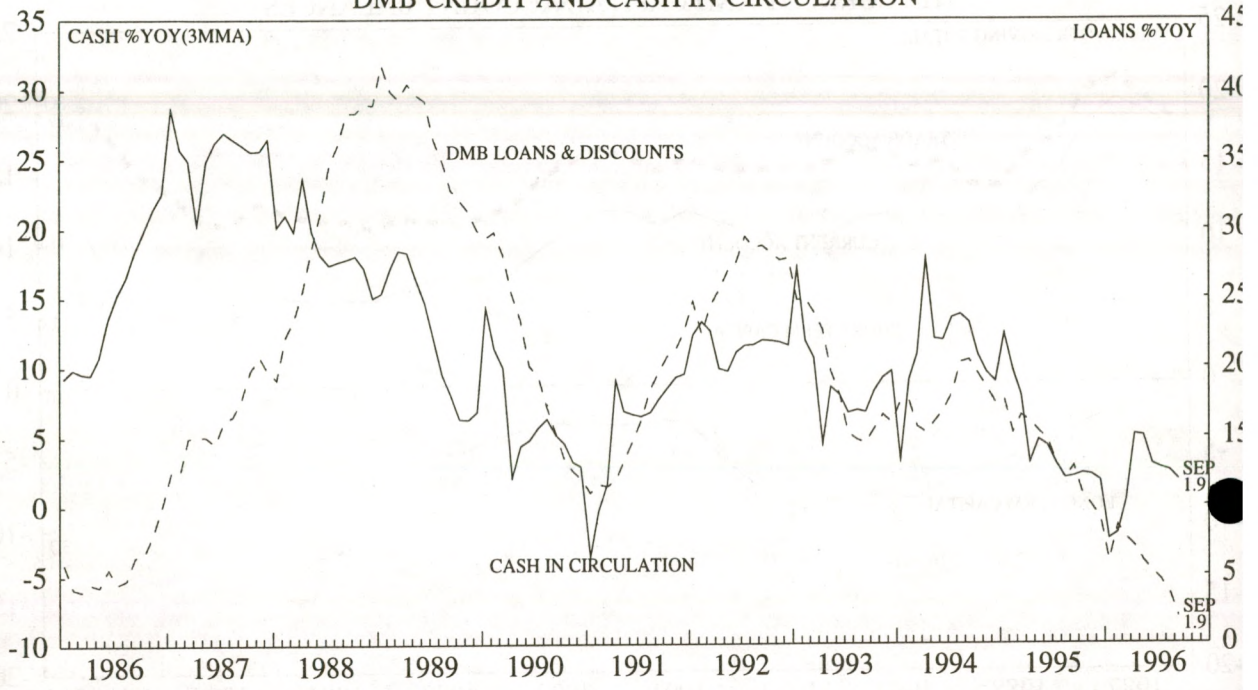
TAIWAN: CHART 7
THE CURRENT AND CAPITAL ACCOUNT BALANCES



TAIWAN: CHART 8
REAL GDP, INDUSTRIAL PRODUCTION AND IMPORTS



TAIWAN: CHART 9
DMB CREDIT AND CASH IN CIRCULATION



Outlook for 1997

The domestic monetary policy easing conducted to date may be sufficient to stabilise the earlier slowdown in M2 growth. It would be unusual if the CBC were to continue to ease domestic monetary policy after the slowdown in M2 and credit has finally stabilised. If the CBC was to ease domestic monetary policy further still and lower interest rates, this would begin to undermine its implicit goal of holding the NT$/US$ stable. A more likely outcome would be for the authorities to wait for exports to recover and for foreign investment to pick up to 1994 levels (chart 7). This would set the following sequence of events into motion.

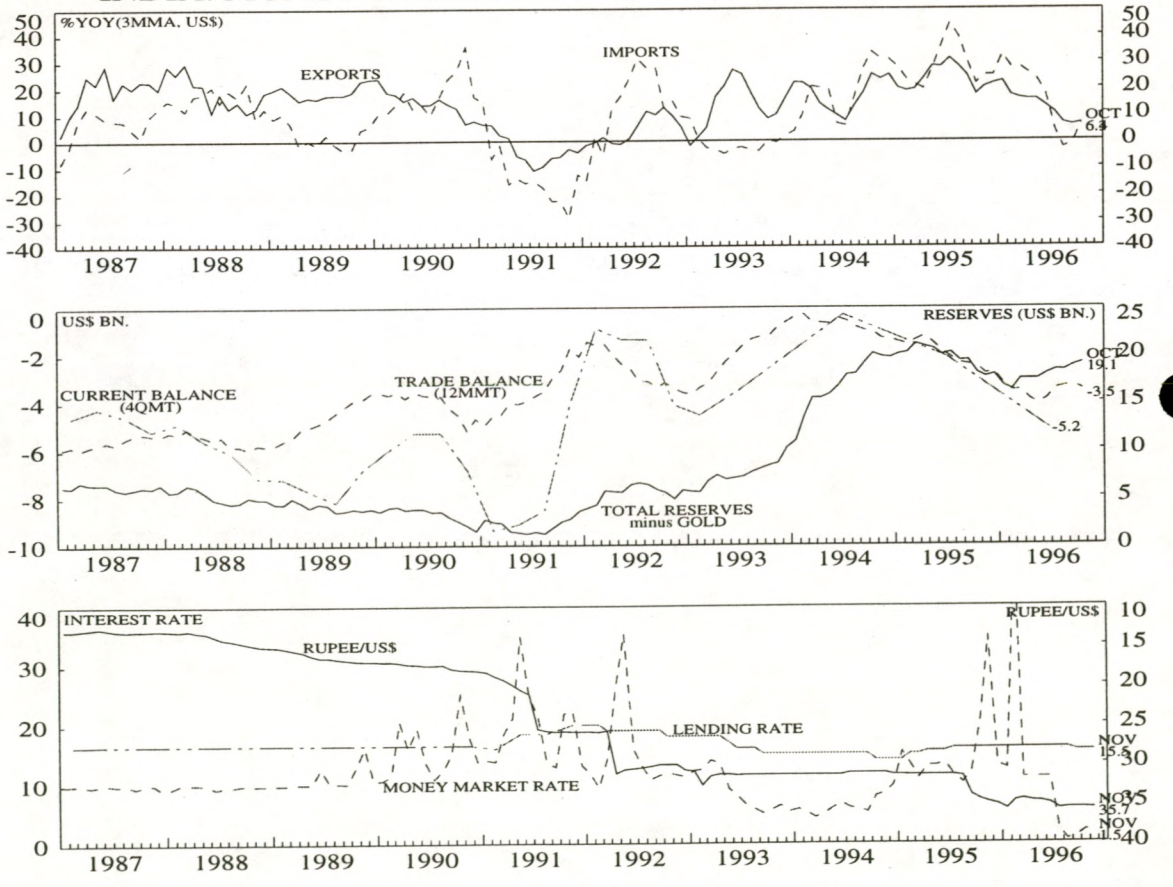
Any strengthening in the balance of payments would place upward pressure on the NT$. If the CBC wanted to keep the NT$ exchange rate stable against other currencies it would have to create additional NT$ deposits as it purchased a greater stock of foreign currency. This would encourage a general reduction in DMB's net foreign assets and concurrent rise in their NT$ assets. Short term interest rates would come down as banks experienced more rapid growth in NT$ deposits. Initially, the price of securities investments would be driven up by these more buoyant liquidity conditions and the ratio of securities holdings to term lending on DMB's balance sheets would continue to increase. However, at some stage this would stabilise as the demand for credit picked up and term lending growth began to accelerate. This would lay the foundations for a more generalised upswing in economic growth.

SUMMARY AND CONCLUSIONS: The Taiwanese economy remains in an export induced slump and bank credit growth continues to suffer from the after-effects of the balance of payments deterioration which started in late 1994. During the course of 1996, the authorities have pursued a progressively more stimulative domestic monetary policy. In recent months there have been strong rises in securities prices and in the volume of securitised lending as a result of these freer liquidity conditions. However, it is too early to expect a sustained rebound in economic activity and rapid increase in the growth of banks balance sheets in the immediate future. Before economic activity can expand, it is likely that there will need to be a more significant improvement in balance of payments conditions and more specifically, a rise in export growth. Although exports may not recover significantly until later in 1997, in the meantime the balance of payments should continue to improve. This would lead to more expansionary liquidity conditions which in turn would provide a positive background for financial asset prices.

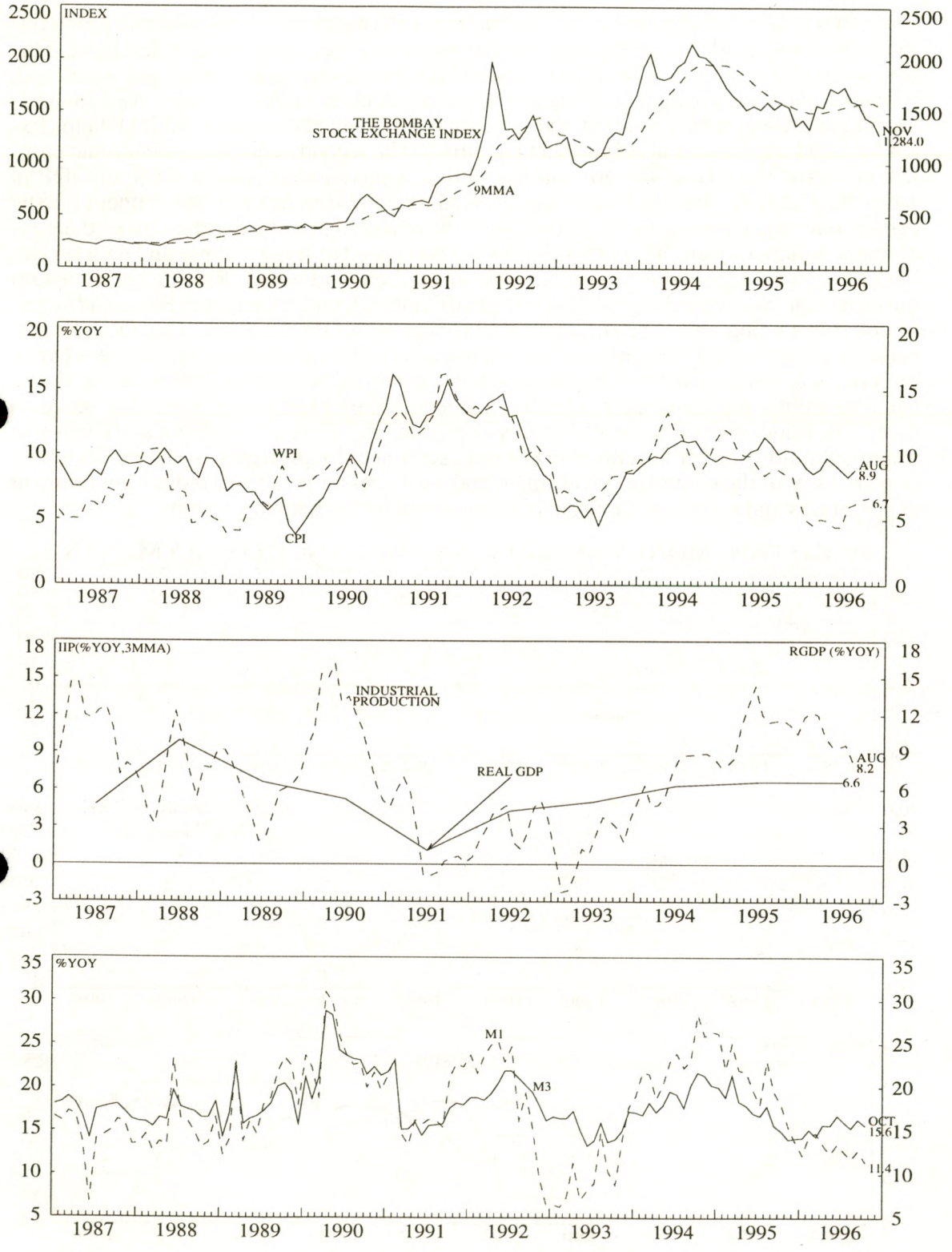
INDIA: PROTRACTED PAUSE IN PROGRESS

India's real economy has been slowing throughout 1996 in response to the tight monetary environment of 1995 and a sharp deceleration in export growth. Sluggish real economic activity can be expected to persist into early 1997 although recent attempts at monetary easing by the Reserve Bank of India (RBI) are likely bear some fruit through the remainder of next year. In its October 1996 "Monetary Policy" statement, the RBI announced a phased lowering of bank Cash Reserve Requirements from 12% to 10%; a move which is likely to result in an acceleration of M3, to around 17% by March 1997. However, while moneymarket interest rates have fallen in line with monetary easing, bank lending rates have eased less quickly. The burgeoning fiscal deficit, the banking system's need to recapitalise balance sheets, and strong private sector demand for credit, continue to compete strongly for available funds -- placing a floor on interest rates at the margin. The RBI is likely to remain cautious about further monetary easing while higher oil prices darken the inflation outlook for 1997. Moreover, monetary easing risks destabilising the rupee although foreign currency reserves have been growing alongside steady inflows of foreign direct and portfolio investment. Following its precipitous collapse in 1996H2, the beleaguered stockmarket is unlikely to recover significant ground until tentative signs of economic growth re-emerge, perhaps in early 1997. Notwithstanding better prospects for economic growth through 1997, the market is likely to remain directionless for the time being amidst volatile political sentiment, and a renewed focus on the momentum of reform in India.

INDIA: MONEY MARKET AND BALANCE OF PAYMENTS



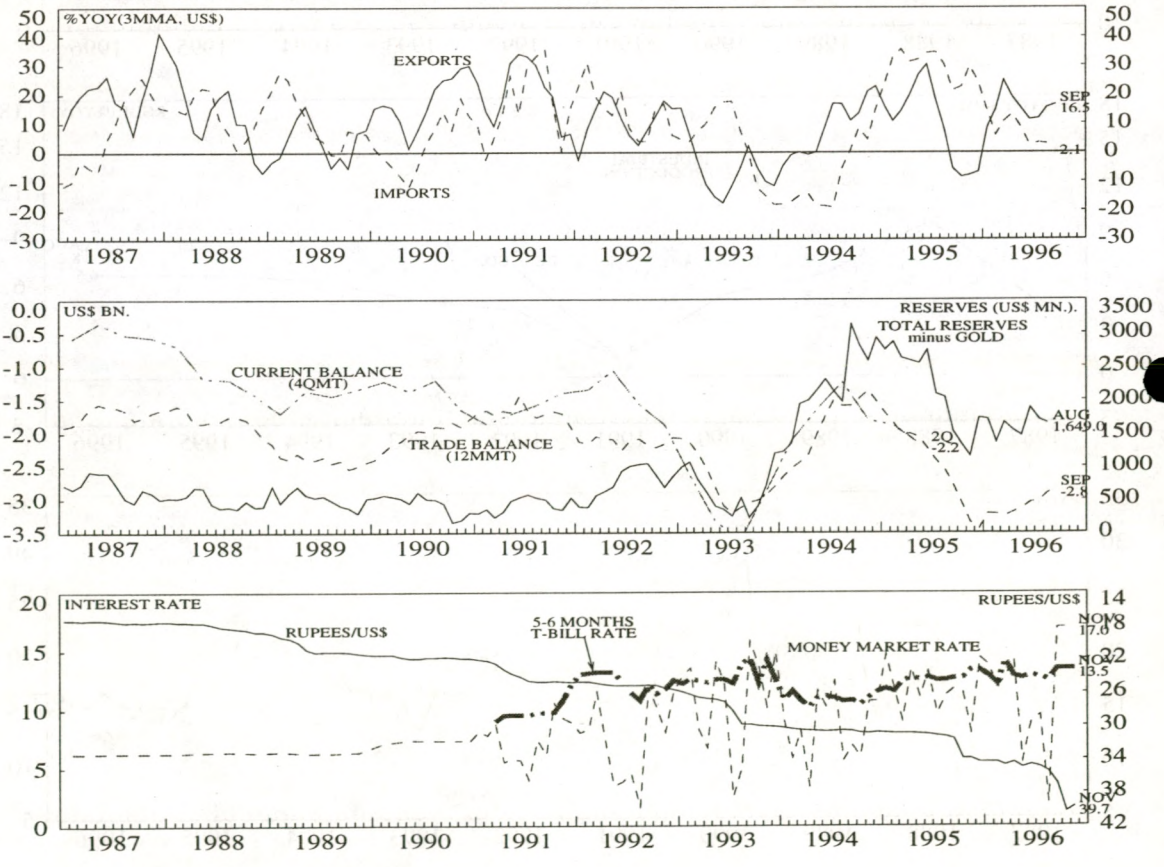
INDIA: MONEY, OUTPUT, GOODS AND ASSET PRICES



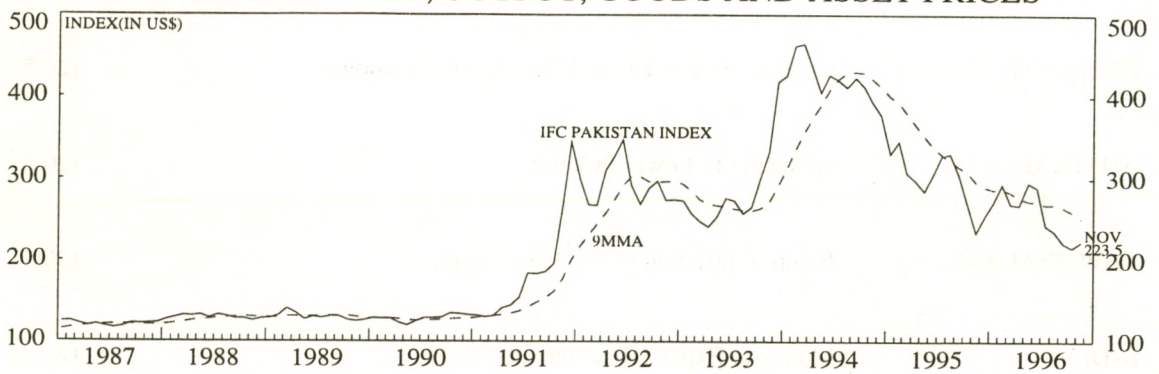
PAKISTAN: CRISIS, CARETAKER, IMPROVEMENT?

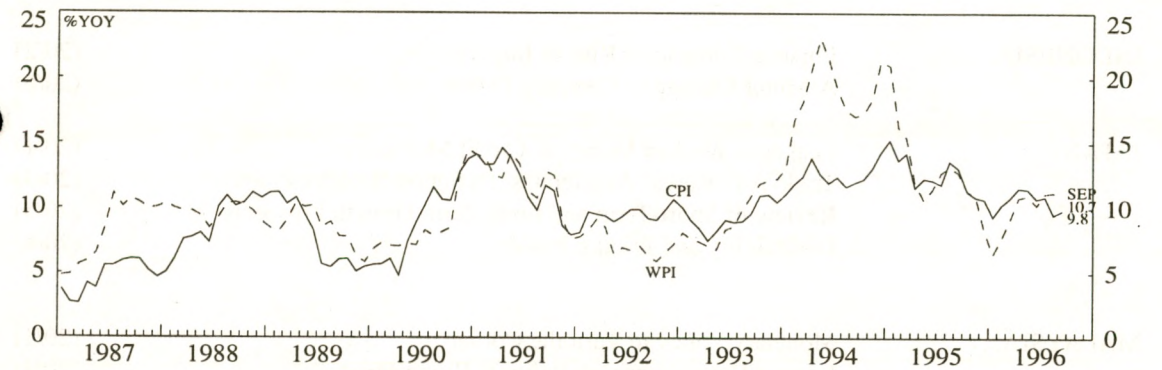
For over a year now Pakistan has been grappling with two main macroeconomic problems. First, the level of official foreign currency reserves has been very low and declining. This has meant that the (otherwise fixed) Rupee/USD rate has taken the strain and weakened, whenever the trade position or foreign investment has deteriorated. To alleviate a weakening balance of payments position, the government has relied on short term IMF help (Extended Fund and Structural Adjustment Facilities). The second major macroeconomic problem concerns the size of the government deficit, equivalent to around 5-6% of GDP in 1995/96. The IMF standby loans were granted on condition that the government pursue certain reforms, the most important of which were aimed at reducing the size of the government deficit. Government expenditures are composed of large defense and debt servicing costs (each equivalent to around 30% of total expenditures). Raising tax revenues through improved tax collection has proved difficult and, under the recent Bhutto administration introducing an agricultural income tax was out of the question. This October, the central bank devalued the Rupee/USD by 8.5% after further depletion of foreign exchange reserves to $760mn. Shortly afterwards, in the wake of the November IMF meeting, Prime Minister Bhutto was removed from office and replaced by a temporary 'caretaker' government. The trade position has been steadily improving this year, although not sufficiently to improve liquidity conditions directly or swing sentiment for portfolio investors. The question arises: will the caretaker government and its successor be able to reduce government expenditures and cut down the fiscal burden carried by the banking system.

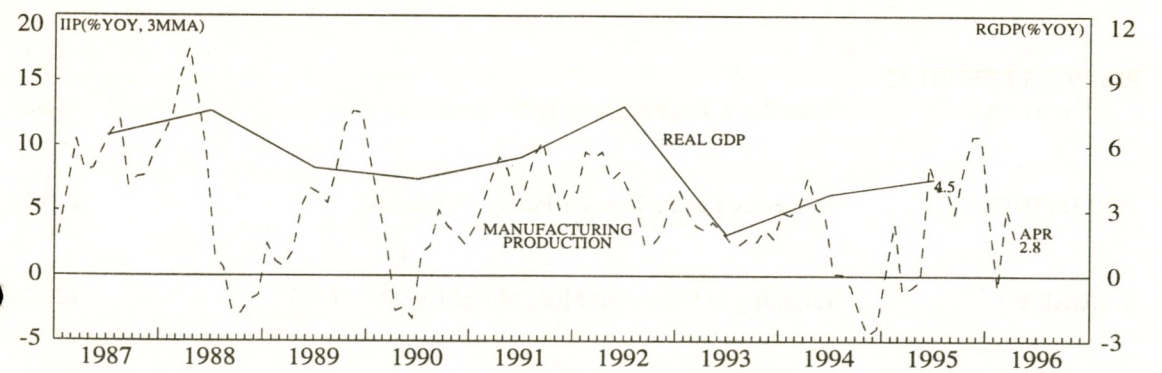
PAKISTAN: MONEY MARKET AND BALANCE OF PAYMENTS

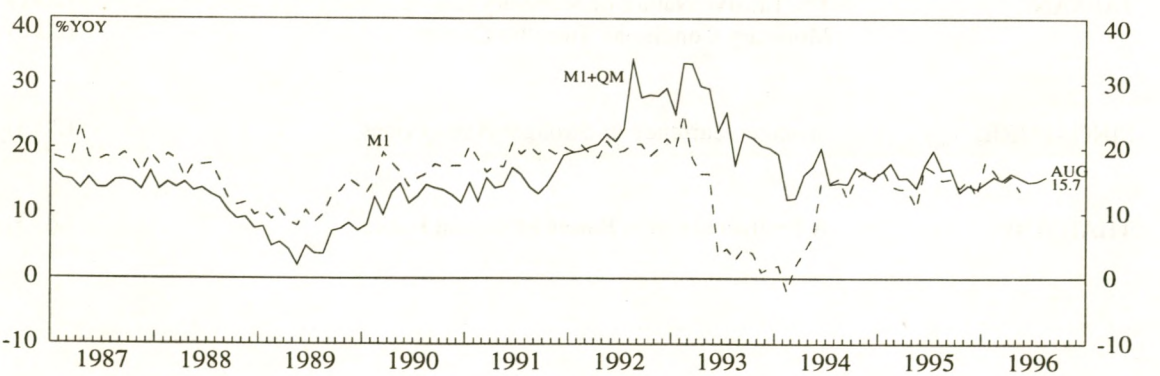


PAKISTAN: MONEY, OUTPUT, GOODS AND ASSET PRICES









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